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INTERNATIONAL EXCHANGE*

FOREIGN EXCHANGES AND THE LEAGUE OF NATIONS.

The subject of my address this evening is International Exchange, with special reference to the problems of which the solution would be rendered practicable through an effective League of Nations.

Before the War, and indeed until recently, international exchange was little understood outside a very limited number of experts. We had so long been accustomed to regard money as having a more or less constant value that the possibility of its becoming indefinitely depreciated did not enter into our calculation. We know now the level of calamity to which a currency may fall. The rouble is almost worthless in the country in which it circulates, and quite worthless everywhere else ; while the currencies of several other European states, though still retaining some trifling value, are reduced to a mere mockery of what they once were.

The Dangers of Misunderstanding.

A misunderstanding of the nature of money and of the problems of international exchange may have very disagreeable consequences. We groan under the present high prices, and our trade is harassed and our commercial pride shocked by the declining American exchange, but in neither case are we likely to find a remedy until there is a general comprehension of the causes. In another field, if money and exchange had been understood by those who framed the indemnity clauses of the Peace Treaty, the substance of an indemnity would not have been abandoned for the shadow of untold millions. A large section of the public is still mystified by our inability to extract these millions, but the lesson must be learnt that the wealth of a nation and its power to pay are not to be found in the pockets

* Speech delivered by The Right Hon. R. McKenna, Chairman of the London Joint City and Midland Bank Limited, before the University of Manchester, November 17, 1920.

of the people, but in the mine, the factory, and the workshop, and in its national power of production.

The hard experience of the last six years is teaching us many things which were not formerly common knowledge. I have no doubt that to-night I shall say a great deal that many of you know already; but if I cannot tell you anything new it may be helpful to present the subject in the form of a connected chain of ideas, and this I shall attempt to do.

I propose to outline the meaning of exchange, and to discuss the part played by gold, and I shall endeavour to enumerate the factors governing exchange between any two countries. Remembering the need for stability of exchange in the interests of international trade, I believe I shall be able to satisfy you that this stability can only be secured amongst nations whose Governments content themselves with an expenditure which is well within their power to meet without borrowing and without excessive taxation. Finally I shall ask you to agree with the conclusion that a League of Nations, with its promise of peace and greatly reduced expenditure on armaments, offers us the only hope of stable exchange, expanding and prosperous international trade, and complete recovery from the ravages of war.

Meaning of Exchange.

First of all, let us look at the meaning of exchange. By exchange we mean the amount of currency or money of one country which will be given for a certain amount of currency of another. Every nation has its own currency, usually quite distinct from that of its neighbours. Like most other currencies, ours derives its value from the law, which declares it to be legal tender for an amount equal to its face value. As this law has effect only in the country in which the currency circulates, the relative value of any two currencies should depend upon the quantity of goods a given amount of money in each country will purchase, or in other words the ratio of exchange between any two countries is normally determined by the ratio of their general price levels.

This rule however is subject to great modification. In the first place international exchange may without any alteration of general price levels show wide fluctuations due to temporary trade conditions. There may be at one period of the year, for instance, a much greater demand for American commodities, such as cotton and wheat, than at another, and we may for the time being have to borrow to pay for them. The Americans will want to be paid in dollars, and will not take an obligation to pay reckoned in British currency unless this currency is sold to them at a reduced rate of exchange. At another period of the year, the process may be reversed and America may need for the moment to borrow from us. In that case we shall lend sterling, with an American obligation to repay which can only be discharged ultimately in dollars, and we shall only take the dollars reckoned at a higher rate of exchange. Behind all temporary movements due to this cause, however, the figure below and above which the exchange will oscillate is that which is determined by the ratio of price levels between the two countries.

German Exchange Explained.

There is a second modification of the rule to which I must draw your attention and which to-day is far more important. It may be said indeed that the rule only applies to nations which have a substantial import and export trade. Where, as is now the case in many countries, there are little or no exports, the exchange will not be determined by the price levels. Let us take for instance the exchange between the United Kingdom and Germany. The value of the mark, which formally was 1s., is now about 1d. If the price levels in the two countries were in the same ratio as the exchange, prices in Germany would now be twelve times as high as in this country. But though prices are high in Germany they have risen nothing like as much as this. There must be some other cause for the great decline in the mark, and we have not far to go to find it.

In Germany there is an immense need for commodities of all kinds. There is not only a serious shortage of raw materials, but the means of production have been largely impaired, and the demand for foreign imports is in consequence abnormally great. At the same time Germany has very few commodities available for export, and the power to pay for imports is comparatively small. As the seller of goods to Germany is obliged to take marks in payment and is forced to hold the marks or get somebody else to hold them for an indefinite period until the German power of production is restored, he only consents to take them at a greatly depreciated rate of exchange. Sooner or later, when normal conditions of production exist again in Germany, and there is a real exchange of commodities with the rest of the world, the rule that the exchange between two countries varies with the price levels current in them will once again apply.

Let me however make an observation here by way of caution to those who may be tempted to speculate in marks. If it be true that the exchange between Germany and England must sooner or later be in the direct ratio of the price levels in the two countries, and that the present price levels in Germany are nothing like as high as the current exchange would warrant, it might be argued that the mark must improve in value. But this conclusion by no means follows. Long before Germany is able to develop her power of production, other causes may be in operation tending to raise prices in that country until they reach a level which would justify the present rate of exchange. Those causes are actively at work now and, if they continue, the hopes of the speculator may never be realised.

Trade Balance.

It is said with truth that the ratio of exchange between two countries depends upon the balance of trade between them—that the country with a balance of exports, including both visible and invisible, will have a favourable exchange. This is however saying the same thing as that exchange depends upon price levels, for only the country in which prices are comparatively low can have an export balance in its favour. If prices in the exporting country rise, the power to export will be diminished and there will be a tendency to increase imports. If the rise in prices is sufficient, the favourable balance will be converted into an unfavourable one. Temporary exchange fluctuations depend

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almost entirely upon the movement of trade for the time being, but the exchange between two countries which are in a normal condition will always tend to return to the ratio determined by their price levels.

Part Played by Gold.

So far I have said nothing about gold with regard either to its use as internal currency, or as a medium for paying foreign debt. Like all other forms of currency, the value of gold currency is determined by legal enactment. If a certain quantity and of a definite fineness be taken to the Mint, it will be coined into a sovereign, which is legal tender for its face value. Gold differs however from silver or copper or paper currency, in that most other countries have a gold law similar to ours. In the United States for instance a certain definite amount of gold is exchangeable for a dollar, and the amount of gold in the sovereign is to the amount of gold in the dollar in the proportion of 4·86 to 1. So long as the law here and in the United States remains unaltered, the par of exchange between the two countries is a constant ratio. If the exchange between any two countries is in a ratio different from parity, there will be an immediate tendency for gold to leave the country with the lower exchange and be sold in the country with the higher. Governments are prone to believe the export of gold to be injurious and when the exchange is so low as to be likely to lead to a considerable export, the aid of the law is invoked and the export is prohibited. In our own case we prohibited the export of gold in April 1919 after the American Exchange had been decontrolled and sterling had fallen to rates which rendered the export profitable. When gold has a less value for internal legal tender than for export it will inevitably be driven out of circulation and hoarded privately, or in the banks, or in the Government treasury.

In what I am saying now I am referring to conditions as we see them to-day. In pre-war times, when in most countries the internal currency had an exchange value at or about its gold parity, gold had a particular use which it no longer has now. Small trade balances between any two countries could be settled by payment in gold, and as it is a commodity easily handled and as its legal tender character is almost universal, it had a special value for this purpose. But to-day these conditions no longer exist. The wide variations of exchange have led most Governments to prohibit the export of gold and it is little used now for settling international balances.

Price Levels.

Coming back to the main theme, we are now confronted by a new question which is of no little difficulty: if the ratio of exchange between two countries is normally determined by the ratio of their general price levels, what is it that governs prices? It is commonly held that the level of prices is determined roughly by the relation between the purchasing power of the public on the one hand and the amount of things available for the public to purchase on the other. But though there is very high authority for this opinion I venture with great diffidence to doubt its accuracy. Let us look for a moment at the course of prices during the last eighteen months and examine how far the theory is confirmed or contradicted by our experience. I assume the expression "purchasing power" means the total of bank deposits and money in circulation, and the expression "things available for the public to purchase" means all articles, whether raw materials or finished goods. The level of prices referred to in this definition must, I think, mean the level of wholesale prices, though later when giving you my own conclusion I shall give a different interpretation to the word "price."

Taking these definitions we find that in the twelve months from June 1919 to June 1920 prices rose by about 27 per cent. During the same period purchasing power also increased, but certainly by not more than six per cent. If, now, this theory of prices were correct, it would follow that during this period production must have declined. But although production did not improve as much as we could have wished, it is beyond question that it was greater at the end than at the beginning of the twelve months. When we look at what has

happened since June of this year we shall find that the theory breaks down again though in an opposite direction. During the last few months the rise in prices has been checked. The latest return shows a decline of 8½ per cent. since June. According to the theory this should mean that production has increased more or diminished less than purchasing power. There has in fact been no change worth mentioning in the quantity of purchasing power, whereas it is a matter of common knowledge that unemployment has been increasing and production declining. It appears then that with purchasing power fairly stationary, it is possible to have rising prices when production is increasing and falling prices when production is diminishing—phenomena which are in direct conflict with the theory.

It seems to me that the theory breaks down because it leaves certain essential factors out of account. I think we shall do well if we try to simplify the problem a little and look at it in the form in which it is familiar to every one of us. We all know something of the cost of living and how far our incomes will go in buying the commodities we need or would like to have. It is a question for us of income and retail price, and it is income and retail price that I propose for a moment to consider.

Velocity of Expenditure.

Take now the total national income, that is to say, the aggregate of the incomes of every member of the community. It is evident that this income is either spent or saved. What is spent goes in payment for goods or services, but I am going to ask you to leave payment for services out of account and to treat the whole of our expenditure as expenditure on goods. In doing so we shall not go far wrong in our conclusion, as the variations in the cost of services and in the amount spent on them are not of sufficient importance to falsify the result. Assuming then that the total national income is either spent on goods or is saved, price will vary with the amount of commodities available for purchase and with the amount of the national income which is spent upon them, a proposition which we may express in another and more convenient way by saying that price varies with the commodities available, the total national income and the rate at which this income is expended, or what we may term the velocity of expenditure.

We have then three varying factors governing price, each of which may be broken up into its constituent parts by anyone who cares to attempt a final analysis. If I were to do so now I should not only weary you but I fear we should all lose ourselves in a tangled maze. The enquiry is difficult and complicated, and I am sure you will be relieved to know that I do not propose to carry it any further this evening beyond saying that the principal factors which emerge from the analysis are production and purchasing power. If we say that price varies with production, purchasing power and the velocity of expenditure, meaning by velocity of expenditure the rate at which the national income is spent, we shall have before us a proposition which though not strictly true is yet sufficiently accurate to serve us in our search for the main elements which govern price.

How to Reduce Prices.

In an endeavour to reduce prices then, we have three lines of attack open to us: we may increase production by working harder, or we may increase production by saving a larger proportion of our income; or we may diminish purchasing power. Each of these processes opens a field for individual action. We may all work harder; we may increase our savings by spending less on consumption; and we may borrow less, and so reduce bank deposits. Every country can have its economic position vastly improved by the exercise of private virtue by its citizens, and I do not think any candid observer would deny that since the Armistice there has been considerable scope for such an exercise of which the inhabitants of many countries have not availed themselves. But apart from all individual effort there is in every nation another power, the power of Government, which by its claims upon its citizens, by its financial policy and by the example it sets, may exercise the very greatest influence alike on production, purchasing power, and national saving.

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Government Expenditure and High Prices.

In the present state of the world I would hazard the opinion that in almost every country excessive Government expenditure is the main factor in forcing up prices. Many states are compelled by the insufficiency of their revenue to borrow and in their case the harm done is apparent to everyone. But when Governments meet their expenditure, however great it may be, by taxation, there is a current belief that the whole duty of the man has been fulfilled. I venture however to express the opinion that this belief is a profound delusion. Very heavy taxation will, I maintain, affect production injuriously, increase purchasing power and raise the velocity of expenditure, and for all three reasons will tend to drive up prices. The causes which produce these results are partly moral and partly economic, and I ask your attention for two or three minutes while I deal briefly with them.

Evils of Excessive Taxation.

First, as to production, I think the proposition is indisputable that heavy taxation restricts enterprise. A business cannot be developed wihout much toil and considerable risk of capital. The stimulus which urges men to venture upon new developments is in large measure the hope of additional profit. They will not risk their capital if in the event of their labours proving successful nearly the whole of the reward is to be taken from them. I do not say that this is necessarily so, but I do say that in the ordinary circumstances of human nature heavy taxation cripples enterprise.

Again, in a progressive undertaking a considerable part of the profits every year is kept in the business. The savings of one year become capital in the next. Additional capital is essential to development, and there is no means of obtaining it except from the savings of the community. Heavy taxation which impounds these savings deprives our commerce and industry of an essential condition of growth.

Next, as to purchasing power, it is not difficult to show how it is increased by taxation. Most traders carry on business not merely with their own capital, but with the assistance of money borrowed from banks.

Their loan requirements rise and fall in accordance with the seasonal demands of their trade, and are essential to its maintenance. These loans from banks, it is true, increase deposits and therefore increase purchasing power, but a marked distinction must be drawn between loans made to traders to facilitate production or the movement of commodities, and loans made to cover expenditure which is not productive. In the former case, there is an increase of commodities made available for consumption which serves as a set-off against the increased purchasing power. As the commodities are paid for and consumed the loan is paid off and the purchasing power reduced. In the latter case, of loans not made to meet productive expenditure, there is no such compensation. If, now, heavy demands are made upon traders for taxation, they are forced either to borrow more from their banks or else to reduce the volume of their business. I know it may be said that the taxation should be paid out of the income which the trader ordinarily spends on his own consumption, but my answer is that in this country for instance Income Tax and Excess Profits Duty are levied upon the whole of the trader's earnings and not merely upon that part of them which he devotes to his private expenditure. We must not forget that with rising prices more money is required to carry the same volume of stock, and that unless this money is obtained from the excess of earnings over expenditure it has to be borrowed. It is in consequence a very common and in many cases inevitable practice in present circumstances for traders to borrow from their banks in order to meet the demands of the tax-collector, and these loans, which increase purchasing power without any corresponding increase in commodities, have precisely the same effect upon prices as if the Government were itself the borrower.

So far we have seen that heavy taxation tends to raise prices by hindering production and increasing purchasing power. We shall find that it has a no less powerful influence upon the velocity of expenditure.

Our practice as a nation before the War was to save about one-fourth of the whole national income. We spent the rest and became accustomed to a certain

standard of living from which we cannot easily break away. The cost of living has risen enormously, but the total national income has not increased in proportion and consequently apart from any taxes we have to pay we can neither spend nor save as we did formerly. When now we have to meet the much higher demands of the State and local authorities, we are driven to restrict our savings still further. I do not think people readily encroach upon the store they have accumulated through the economies of past years, but they find it more and more difficult to lay aside any portion of their income after providing for their ordinary expenses of life and the charge for rates and taxes. The savings which formerly were employed as productive capital of every kind are now taken in taxation and mainly spent unproductively, and there is in consequence a great increase in what we have defined as the velocity of expenditure. This increased velocity has been the cause of the phenomenon which we have seen since the Armistice and to which I have already called attention, that an increase of production has been accompanied by rapidly rising prices.

THE LEAGUE OF NATIONS.

I am now coming to the conclusion of my argument. We have seen that international exchange is normally governed by the ratio of the price levels in different countries and that price varies with factors under the control both of individual citizens and of Government. We have seen that Government expenditure is a cause of rising prices and works with double effect when the expenditure is met with borrowed money. If we wish to check the rise in prices and bring about a condition of stable exchanges Government expenditure in all countries must be reduced. Our remedy should be one which assists Governments to economise. Inefficiency, want of method, weak and foolish policy, may account for a good deal of extravagance, but will not account for everything. All over the world Governments are spending millions on protecting their country from what they believe to be the real dangers which threaten them. It may be impossible to cure inefficiency, want of method, and weak and foolish policy, but Governments can be relieved from the terror of foreign menace. The whole world is in a condition of instability, which in some countries has developed into violence and disruption. The external dangers are not fantastic. In present circumstances they are real. We must look either to constant meetings between all the Powers to settle the inevitable and innumerable disputes which arise on every side, or we must live in a state of perpetual war. The instrument of the one alternative is the League of Nations: the instrument of the other is the huge machinery of armaments, the expenditure on which is no longer merely exhausting the world, but actually destroying it. The choice before us lies plain. One or other we must have as the means of quieting the world's disorders—the old way of victory to the strongest, measured in terms of physical force, or the new way of arbitration along the healing path of mutual adjustment and consent. If ever the time could come when the tragic futility of war stood finally exposed before a disillusioned world, that time has come now. If we in our generation fail to clutch at the one great hope which the League of Nations offers—a hope which once realised would transform the future of the world—we shall have failed to learn the lesson which the long years of sacrifice and suffering have written so plainly across the desolate countries of Europe.

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