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ADDRESS BY DR. M. W. HOLTROP -
EUROPE'S MONETARY PROBLEMS TODAY

Mr. D. Crena de Iongh, Executive Director for The Netherlands, has suggested that the attached copy of address by Dr. M. W. Holtrop, before the Commonwealth Club of California on September 19, 1952, would be of interest to the Executive Directors.

Attachment

Distribution

President
Vice President
Assistant to the President
Department Heads

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Address by Dr. M.W. Holtrop
before the Commonwealth Club of California

San Francisco, September 19, 1952

EUROPE'S MONETARY PROBLEMS TODAY

1. As an old member of this club, who in years gone by has so often joined this luncheon to listen to the many distinguished Americans and foreigners who passed through San Francisco and who were found willing to address the members of this remarkable institution I want to say to you that I feel particularly thrilled to have been deemed worthy of the honour to now, for once, partake in this luncheon from the other side of the table.

As a former San Franciscan I realise that for you Europe is a far away place and that its continuous problems sometimes seem to become somewhat annoying. After all it is only natural that every human being should look upon the world with himself at the center and for you Californians Europe is just about one of these remote places you would once in a while rather like to forget about. And yet, as members of this Great Nation, which in a shrinking world cannot keep itself in isolation, you have to admit that in the world's balance of economic power Europe still holds a place that ranks only second to that of the North American continent. The 17 countries and territories who have joined the Organization for European Economic Cooperation in Paris have a population almost twice as large as that of the U.S.A. Their combined production of steel is about 1/3rd, their production of coal about 40%, their shipbuilding more than 80% of the world's. Their participation in international commerce exceeds that of the United States. Their combined exports and imports in 1951 amounted to $34 billion, as against $27 billion for the U.S.A. In short, it seems well to realize that these countries still represent an economic power of the first magnitude and that it is therefore still worth while - even when living so far away from them as here in California - to try to understand their problems, and, if possible, to cooperate in solving them.

2. In my opinion Europe's present monetary problems cannot be well understood without some reference to the economic and monetary situation in which the European countries found themselves at the end of the war and to the different policies these countries followed in order to restore their economies.

From the monetary point of view the war period had been characterized by the development of a tremendous repressed inflation. Everywhere the larger part of the national product was diverted to war purposes, without sufficient taxation or long term borrowing to finance this expenditure. On the other hand price inflation was prevented by most rigorous price and wage controls and by a system of rationing. Consequently the public found itself gorged with money and money claims which could neither be turned into consumption nor into adequate investment. This holds particularly true of the occupied territories, which were stripped of all their moveable wealth,

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their stocks of raw materials and finished goods and even of a large part of their productive equipment itself. One might really say that in the occupied countries the war was characterized by a kind of Midas-touch: everything of value to the occupying power was turned into money, but, alas, not gold, but paper money "covered" by an immense, but valueless, claim, held by the central banks of the occupied countries against Germany. Apart from this process of turning real wealth into paper money there was the immense physical damage of war and occupation, the destruction of housing, of the railroad system, of the plants and factories, yeah in some countries like my own, of the land itself, by wholesale inundation.

As a consequence most European countries found themselves faced at the end of the war from the physical point of view with a disrupted economy and a terrible shortage of both current stocks and capital goods and from the monetary point of view with an immense amount of accumulated purchasing power in the hands of the public and no goods to satisfy this potential demand.

To give you just an illustration of the magnitude of the problem, I want to mention that in 1945 the Netherlands found themselves with a monetary circulation 4 times as high as before the war, with an industrial production of little more than 1/4 of prewar and yet with a wholesale price level which exceeded that of 1939 by only 70%.

In some respects still worse was the situation of that one European country that escaped both occupation and defeat: the United Kingdom. It exhausted in the war effort the major part of its foreign investments and reserves and moreover incurred a tremendous floating debt towards the members of the sterling area, which was not - like the German floating debt to the occupied countries - simply wiped out by the economic benefit of defeat. Consequently Britain had not only to face the accumulated money claims of its own public but also the accumulated money claims of the members of the sterling area, against which the sterling balances in London were being held as a reserve.

3. How did the European countries solve the monetary problem with which they were faced?

As already said, this monetary problem consisted of the tremendous gap between the nominal purchasing power in the hands of the public and the real supply of goods available to satisfy the potential demand. In other words, it implied an acute disequilibrium between the amount of liquid wealth in the hands of the public and its willingness to hold this liquidity instead of to spend it.

We can distinguish in the after war policies of the different European countries three fundamental methods of approach to tackle this problem, which I like to call:

(1) the Benelux solution
(2) the British solution
(3) the Franco-Italian solution

When making this distinction, which I consider of very great usefulness in helping us to understand the monetary problems of today, I want to say beforehand that firstly in many countries the choice between these three different methods of approach was perhaps never taken consciously, secondly that hardly any of the methods to be described was ever put through to its full logical consequences and thirdly that therefore none can be deemed to have been completely successful. Nevertheless the differences are important and still clearly carry their consequences.

(1) The Benelux solution, followed both by the Belgian and by the Netherlands Governments, consisted in a drastic monetary reform, which had the object of wiping out the excess liquidity in the hands of the public by a preliminary blocking of the total monetary circulation, a gradual release of what could be considered a normal amount of money and the elimination of the remainder by special taxation and forced consolidation in bonded debt. The idea was that by this operation a proper relationship between the volume of money and the volume of goods could be restored, and that consequently the immense injustice of price inflation, with its annihilation of past savings could be prevented. On the other hand it was also expected that by this action the pressure of latent inflation could be taken away, thereby opening the possibility of restoring a free economy, with no rationing or price controls, as soon as the period of physical shortages of goods would be over. The Benelux method of approach therefore promised, if successful:

(a) no price inflation
(b) a quick return to a free economy

(2) The British solution had likewise the object of preventing price inflation. Not however by a surgical operation but by a prolonged cure of continued physical controls and rationing, as in the war years, combined with a policy of systematic budget surplusses that would, in due course, absorb the excess of purchasing power in the hands of the public. This method therefore promised:

(a) no price inflation, but
(b) only a slow return to a free economy.

(3) The Franco/Italian solution finally rejected both the ideas of monetary reform and of prolonged physical controls but had consequently to accept the full impact of excessive liquidity on the price level, resulting in enormous price increases and a heavy depreciation of their money as compared with its pre-war value. The Franco/Italian approach therefore meant:

(a) price inflation, but
(b) a quick return to a free economy.

With the acceptance of price inflation it brought the disadvantage of jeopardizing the public's confidence in the value of money.

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These different policies and the relative success with which they were carried through largely explain the different position of these currencies at the present day. I need only mention for example that, measuring by the index numbers of wholesale prices, we find that by the end of 1947, England had succeeded to maintain the full dollar value of its currency, the Netherlands 75% of the dollar value; Belgium 54%; France 17% and Italy only 4%. This same order does not hold good, however, for the achieved elimination of the excess of monetary circulation. Whilst in the U.S.A. in 1948, monetary circulation bore again the same proportion to national income as pre-war and whilst in Italy, France and Belgium relative circulation was already a good deal lower than pre-war, Holland in 1948 still showed a circulation that was some 10%, and Britain even a circulation that was proportionately some 50% higher than pre-war. The consequences did not fail to show in the ensuing years. Britain and Holland for the time being continued to suffer from latent inflation whilst Italy and Belgium clearly did not. That Holland, after all, yet succeeded to overcome latent inflation, even though the monetary reform had not been 100% successful, was due to the Marshall aid, which enabled the central bank to sell foreign exchange to the public and thereby continue to withdraw money from circulation, without exhausting its foreign exchange reserve.

4. Meanwhile, it was not only latent inflation, left over from the years of war, that haunted the European countries. Nearly all of them have also gone through some period of active new inflation. This new inflation took different forms. Sometimes it was due to excessive government expenditure, financed by recourse to the banking system. More generally, it has been due to credit expansion for the benefit of private business. In some rare cases, finally, it was caused by the creation of money in order to keep down the long term rate of interest by pegging the bond market.

In all these cases, where new purchasing power was added to the normal stream of purchasing power which is constantly engendered by the current process of production, European countries tended to be involved in that peculiar phenomenon which in smallish countries is always the result of inflationary developments: a deficit in the balance of payment.

In a big country like the United States, where only about 4% of the national income is spent abroad, inflationary developments are very slow to show up in the balance of payments. Not so, however, with the European countries. With them the ratio of foreign trade to national income is quite different: in countries like the Netherlands and Belgium imports only already amount to about 40% to 50% of their national income. Consequently, a much larger part of any additionally created purchasing power tends to be directly spent abroad. Whilst, therefore, in the United States inflation is mostly characterized by booming business and internal price increases, European countries are immediately confronted with a shortage of foreign exchange to pay for their increased imports. Now, certainly, price increases and a gradual deterioration of the value of money, as experienced by the U.S.A., are bad enough. But balance of payments difficulties, which on a certain moment threaten with total bankruptcy, are certainly worse. It is for this reason that before the war, European countries were generally used to hold ample monetary reserves. In Holland, before the war, gold and foreign assets of the Netherlands Bank, were sufficient to pay for more than a year's imports. In the middle of last year total net reserves dropped to just about one month's imports.

Under such conditions you should not be surprised that European countries, when faced with inflationary developments, tend to take refuge to direct import controls to stave off the threatening exhaustion of their reserves.

Of course, direct import controls only mean a curing of symptoms. They do not take away the inflationary impulses, which notwithstanding all controls, continue to nag at reserves. The inflationary purchasing power which cannot satisfy itself on imported goods, will turn to the home market and gradually eat away the export capacity of the country. In the long run, therefore, import controls will not help. It is inflation itself, that has to be prevented.

But while accepting this maxim, we should realize ourselves that, by the prevention of those crude forms of inflation that are under direct control of the governments and the central banks, we shall not have done away with any and all inflationary developments and any and all balance of payment problems. Of course, we can prevent governments to run into cash deficits. It is more difficult already to prevent too strong an expansion of bank credit to the private economy. But we can hardly control at all in a free economy that subtle form of inflationary development that results from a tendency in the business world to run down on its own cash reserves and other liquid assets. And yet, that tendency leads to the same consequences as pure deficit spending by the Government: it adds to the demand for goods without anything being added to supply.

The magnitude of this latter problem can best be illustrated from the experience of the Netherlands. Before the war, monetary circulation in my country amounted to somewhat less than 50% of national income. By the end of 1949 that proportion was just about reestablished and there seemed to be some reason to believe that circulation was back to normalcy. Yet in the period from January 1st 1950 to June 30, 1951, monetary circulation went down by 780 million guilders, i.e., by more than 10%, and for every guilder withdrawn from circulation the Netherlands Bank had to put up a guilder's worth of foreign exchange. Then, by the middle of 1951 the tide turned. Monetary circulation increased in one year's time by 904 million guilders and for every guilder added to the circulation the business community turned in one guilder's worth of foreign exchange with the Nederlandsche Bank. Because, mind you, the circulation did not increase by any inflationary development, but simply because the business community after having strained its liquid reserves to the utmost to buy raw materials when prices went up, suddenly changed its mind and started to run down on stocks and to increase its liquidity.

It is this latter type of inflationary and deflationary development which is the result of the free dispositions of a free economy that will continue to cause, also in the future, alternative periods of balance of payment deficits and balance of payment surpluses. If they occur, they should not give rise to alarm and still less to the application of any physical controls. They do however ask for monetary reserves, sufficiently strong to carry the load.

5. I think, I have by now given you a fair idea of the ghosts that haunt the European ministers of finance and governors of central banks. Inflationary developments of different types constantly threaten to disturb the equilibrium of their foreign accounts. The latent inflation left over from the war, the active new inflation caused by deficit spending or credit expansion and finally that subtle inflation that results from changes in the liquidity preference of the public.

These threats, partly controllable and partly uncontrollable, are to be faced with monetary reserves far smaller than ever existed before the war. When realizing all this one wonders how these European countries ever succeeded at all to reestablish after the war some sort of free international trade. How did they?

Inter-European trade, after the war, went through three successive phases. The first was the period of the bilateral payment agreements, the second the period of the Basle clearing, the third the period of the European Payments Union.

In the first phase trade between two separate European countries took place on a strictly bilateral basis. Every set of two countries allowed one another a certain credit margin, beyond which, generally, payment in gold had to be made. Since nobody could afford, or was willing to pay gold to another European country all international trade had to be put under strict governmental control. Government officials sat together to negotiate the exact amount of goods that would be exchanged between the countries, every one trying to buy as many "essentials" and to sell as many "non-essentials" as could be. In terms of American Interstate Commerce the system meant that the State of California could not buy more in Arizona than Arizona bought from California, and so on. If, for argument's sake, Arizona could only sell its copper and cotton to the East coast, then consequently it could buy neither oil nor lettuce in California, but would have to buy its oil in Pennsylvania and would cut out the lettuce anyway, this clearly being a frivolous non-essential.

The second phase of inter-European payment relations was the Basle clearing arrangement, which started in October 1948 and was managed by the B.I.S. in Basle. All members agreed to a clearing of mutual claims and debts, on condition that such clearing should lead to a reduction and never to an increase of indebtedness to any other partner. This arrangement meant some improvement on the bilateral system, but not very much, as nobody could really be sure that its claims on one country could be used to settle its debts to another. The tendency to equilibrate trade on a bilateral basis therefore continued.

6. An enormous improvement and a real multilateralization of the inter-European trade was brought about by the European Payments Union in 1950 which initiated the third phase in after-war European payment relations. This union meant the creation of a central pool to which at the end of each month all existing bilateral debts and claims were transferred, so that every country was only left with one debt - or credit relationship to the community. Members were allowed a certain quota, on the basis of their participation in European

trade in 1948. Total quota amounted to $4 billion. Every country (except some of the smaller and weaker members) was allowed a credit margin with the Union of maximum 60% of its quota and, on the other hand, had to allow the Union a same margin of credit. When being a debtor a country could first make use of a free margin of credit to the amount of 20% of its quota, after that it had to pay increasing proportions of gold, starting with 20% and finishing with 80% gold payment. Creditors on the other hand, after having extended to the Union a free credit margin of 20% of their quota, subsequently received 50% in gold and gave 50% further credit.

The complete and automatic clearing of inter-European payments has brought an enormous change in world trade. Now, for the first time, European countries could - in the European sphere - stop worrying about bilateral trade relationships, they could buy and sell in the most favorable market, irrespective from other considerations. The system, moreover, does not only apply to the European countries proper, but to their whole currency areas, including the whole Sterling area, the whole French Union, the Belgian Congo and Indonesia. So, for all practical purposes, almost the whole free world outside the Americas was welded into one currency area, where countries needed no longer to ask themselves whether they could afford to pay or to receive any specific currency involved in any specific transaction, but had only to take care that their position with respect to the collectivity of their partners remained in equilibrium.

Moreover, the 60% credit margin which the European countries allowed one another implied a strengthening of the potential monetary reserves of the partners by 2.4 billion dollars. This enabled them to view with equanimity any reasonable fluctuations in their net debtor or net creditor position with the Union.

7. The European Payments Union has sometimes been accused of only creating one big weak-currency area and therefore leading away from the aim of restoration of general convertibility. Nothing could be less true. Weak currency areas are characterized by inflationary conditions, which necessitate general direct controls on imports. E.P.U. has, however, clearly proven to be a very important instrument in the battle against inflationary policies and has greatly helped to reduce direct controls in inter-European trade.

The fact, that any Member of E.P.U., when running into a deficit with the Union, had to make increasingly heavy gold-payments, has helped to bring home to Member governments the necessity of following anti-inflationary policies.

At the same time the Union, by obligating Members to reduce direct import controls and by gradually setting up a standard of 75% liberalization of all non-government trade, has lessened the possibility for Member governments to rely on physical controls to keep their balance-of-payment situation in equilibrium. It has consequently promoted the tendency to achieve this end by appropriate financial policies. In doing so, E.P.U. has clearly helped to re-establish one of the fundamental conditions for a return to general convertibility.

The two outstanding examples of the beneficent influence of E.P.U. in these respects, viz. the promotion of sound monetary policies and the reduction of restrictive controls, have been the cases of Germany and the Netherlands.

At the end of 1950 it became clear that Germany was running a current deficit in E.P.U. that threatened to exceed both its quota and its capacity to make the necessary gold payments. The management board of E.P.U. undertook an investigation of the German case, experts were sent to Germany to consult with the authorities, a temporary extra-credit was given to Germany. But also, and in accordance with the advice of the experts, the German monetary authorities stepped in. Restrictive credit policies were introduced, the rate of discount was increased, budgetary policies were reviewed. To stave off an acute crisis it was also necessary to temporarily introduce strict import controls. But the effectiveness of the financial measures taken, was proven by the fact that, from then, Germany's position in the E.P.U. continued to improve. Consequently the imposed import restrictions could be discontinued and Germany at the present moment ranks among the main creditor countries of E.P.U.

No less sensational was the reversal of the position of the Netherlands. In the second quarter of 1951, some time after the German crisis, also the Netherlands seemed to be on the way to exhaust its quota in E.P.U. and - having become an extreme debtor - had to explain its position before the Management Board.

However, the Netherlands Government, and the central bank, had already taken appropriate steps. Being convinced that, by now, latent inflation was over, they directed their efforts to the prevention of further new inflationary developments. Special measures in the credit field, aiming at making the central bank's rate of discount effective, had already been introduced in January 1951. In April the rate of discount was increased to 4%, which meant that most banks, when further increasing their commercial loans, had themselves to borrow the money from the Netherlands Bank at 4%. In March the new government, convinced that the persistent balance of payment deficit clearly indicated that the total of consumption and investment in the country exceeded the available resources, and at the same time facing the necessity of increased military expenditure, announced a policy of reduction of consumption by 5% and reduction of investment by 25%, both to be achieved by financial measures. These were: (1) increased taxation, (2) reduction of subsidies on food and (3) restrictive credit policies. Liberalization of trade was maintained; no new import restrictions were introduced. Real wages, with the full cooperation of the trade unions, were reduced by 5% as compared with a year before, by allowing an increase of the cost of living by 10% to be matched by a wage increase of only 5%. The results soon became apparent. In August the balance-of-payments situation of the Netherlands reversed itself; since then, Holland has continued to be a net-creditor in E.P.U. and at the present moment its cumulative net-creditor position is only exceeded by that of Belgium and Germany.

8. Since then Germany and the Netherlands have been succeeded as the two largest debtors in E.P.U. by France and England, or better by the French Monetary area and the Sterling area. After the strain on the raw material consuming countries, now followed the strain on the raw-material producers. Will also France and England soon be able to reverse, or at any rate to equilibrate their position? This will partly depend on developments in the raw material consuming countries who must soon discontinue their present tendency to run down on inventories. It will, more largely, depend upon fundamental monetary conditions in France and the Sterling area itself. Both countries have found it necessary, in order to overcome the crisis in their relationship with E.P.U., to heavily rely on direct import restrictions. They have also taken recourse to monetary measures, though, as it would seem, not to such radical ones as the Netherlands government applied in March, 1951. The near future will show whether their policies are going to meet with sufficient success. The test of this success will not be whether they succeed in putting their E.P.U. deficit to a temporary stop. That might simply be the result of restrictions on imports. The real test will be whether they are able, within a reasonable time to discontinue their present import restrictions and again take part in the liberalization of trade, which is one of the main objects of E.P.U. If they are not, this would clearly indicate that inflationary conditions in their areas still prevail.

9. Strange as it may seem, it is not the problem of the persistent debtors, but far more the problem of the persistent creditors that really constitutes a threat to the existence of the European Payments Union. Persistent debtors, after all, after having exhausted their quota, have to pay 100% gold to the Union, which is certainly a sufficient incentive for them to try to do something about their position. Persistent creditors, on the other hand, are receiving at least 50% payment in gold and have sometimes, after exceeding their quota, received a great deal more. They just might like it! Moreover, there is generally much less a creditor country can do to restore its position to equilibrium than a debtor can.

Appropriate monetary policies can only bring about a long-run equilibrium in the total balance of payment of a country. They can never guarantee the attainment of equilibrium with any separate currency area particularly. The E.P.U., however, is nothing else but a separate currency area, all be it a large one. It does not include the dollar area nor some minor currency areas with whom most European countries still maintain bilateral accounts. A country, following appropriate monetary policies and consequently enjoying long-run equilibrium in its over-all balance of payments, may very well find itself in the position of having a deficit with one currency area, such as the dollar area, and a surplus with another, such as the E.P.U. area. Such has, from the very beginning of E.P.U., been the position of Belgium. Fundamentally, the Netherlands are in just the same position. For the natural flow of commerce of these two countries has always been such that they bought more in U.S.A. than they could sell there and that they earned the dollars to pay for their deficit by surpluses with other countries, such as Congo, Indonesia, and the raw material countries belonging to the Sterling area. The natural flow of commerce would, therefore, lead Belgium and the Netherlands to have a surplus in E.P.U., to be paid to them in gold or dollars, with which they could pay for their deficit with the United States.

But since, in E.P.U., there are no persistent debtors who are able or willing to pay gold or dollars and since, therefore, E.P.U. has no continuous Dollar income, it cannot continue to pay out Dollars to persistent creditors. Consequently, the persistent creditors, if they didn't want to see their Dollar reserves dwindle away whilst at the same time accumulating claims in E.P.U., are forced to cut down on their dollar imports, by direct controls. If they did not, they would in the long run go broke or when insisting on gold payment to E.P.U., would bust E.P.U.

The fundamental difficulty with which E.P.U. is faced in this respect is the fact of the continued existence of the famous dollar-gap. This dollar-gap means nothing else but that in the mutual relationship between the dollar world and the non-dollar world, the first - and more especially the U.S.A. - continues to run a balance of payment surplus and the non-dollar world as a whole continues to run a deficit. We cannot, at the present moment, go very deep into the causes of this phenomenon. It is clear, however, that if there existed no countries with a balance of payment deficit, it would be impossible for the U.S.A. to have a surplus.

Therefore, as far as there are countries which, due to inflationary conditions, continue to run an over-all balance of payment deficit, we are certainly justified to lay part of the blame for the dollar-gap on them. It is, on the other hand, also clear that in as far as the U.S.A. by their own policies prevent other countries to better restore equilibrium - and I want to remind you in this connection of the restrictions on the import of cheese and of other protectionist tendencies in this country - some part of the blame for the dollar-gap must also be attributed to the United States itself.

But, certainly, no part of this blame can be laid on those countries who have managed to restore equilibrium in their over-all balance of payment. And yet - as we already saw - these countries may very well find themselves forced to discriminate against American imports and get a lot of blame for that for no other reason than that the natural flow of commerce at the given rates of exchange leads them to have a deficit in their balance of payment with the dollar area and a surplus with others.

10. We may conclude that the monetary problems which still perplex our world find their fundamental cause in the continuance of inflationary policies and inflationary conditions in parts of the non-dollar world and are intensifi by impediments to the free flow of international trade in the dollar area. It is the combined effect of these two causes that leads to the continuance of the dollar-gap and to the impossibility of restoring general convertibility The discriminatory trade and payment restrictions that exist in countries that have restored their over-all balance of payment equilibrium are not a cause, but an unavoidable consequence of the continuance of non-convertibility

If our present pains are to be cured, we must not lose sight of these fundamental truths. All efforts must be concentrated on the fight against inflationary policies and against the continuance of inflationary conditions outside the Dollar area. Deficit financing unwarranted credit expansion and excessive liquidity must not be condoned, wherever they show themselves, be it in Europe or elsewhere. The example of so many European countries has clearly proven that in due time and with appropriate monetary and financial policies such conditions can, in one way or another, be overcome. At the same time, the barriers which impede the flow of foreign goods into the United States must be lowered as much as possible.

It is only thus that we can hope to overcome the monetary problems that still beset Europe and our world in general and that we can hope to realize that aim, to which almost all countries in the world have pledged themselves by accepting membership of the International Monetary Fund in Washington: the re-establishment of free convertibility between all currencies that serve the free world.