Fiscal and Currency Standards as the Future Measure of the Credit of Nations

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By Hon. Paul M. Warburg, Former Member,
Federal Reserve Board

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Some weeks ago I was requested to write an article about American and European banking methods and when I averred that at present I did not have the necessary time, it was suggested that I revise and bring up to date an earlier essay on the topic, written by me about ten years ago. As a matter of curiosity, I re-read that earlier contribution from the point of view of ascertaining to what extent "modern improvements" would have to be added in order to make it serviceable. As you may imagine, I found it as impracticable to revamp the old material as it would have been to use automobile parts of 1908 in manufacturing a modern aeroplane. While the fundamental principles had remained the same, the problems and methods had changed too drastically.

With this difference, however, that in contemplating the history of the development of the gas engine we face a distinct and permanent advance in the art, whereas in studying present banking conditions we are dealing not with progress, but with a form of aberration or disease largely of a temporary character.

While the theory of banking is the same today as it was in the past, in practice its most fundamental feature has been almost universally abandoned at this time.

The essential characteristic of ante-be
banking in leading countries was that t
paper circulation and their deposit liabil
were protected by, and therefore kept in a
tain relation to, large gold reserves asseml
in their central banks. These central inst
tions, in turn, could strengthen themselves
drawing on the floating gold supply carriec
the pockets of the people and in the vaults
the banks, or by collecting their holdings
other nations' gold obligations.

A gold country repudiating its obligation
pay in gold would have been deemed a ba
rupt, and a country permitting the existence
a substantial gold premium, be it domestic
in the form of an excessive discount on its f
eign exchanges, would have been considered
being headed for insolvency, a condition whi
would have caused widespread alarm.

The fear not to be able to fulfill their go
obligations, the wish and will, at all hazard
to ward off any such catastrophe, was tl
strongest directing force and regulator, n
only of the financial, but even of the econom
policies of such countries. Rather than to expos
themselves to the danger of a suspension c
gold payments, they would resort to suc
weapons as high discount rates, high impoi
duties or taxes, the export premium, borrowin
in foreign markets on even onerous terms, o
to any other means of counteracting demand
caused by an overwhelmingly adverse trad
balance.

The war brought about a complete reversa of these doctrines and traditions. The will to win, of necessity, became stronger than the desire to preserve gold standards, and inasmuch as victory was dependent upon ammunition, food and other supplies, goods became more important than gold, and a policy dictated by the flow of gold was quickly subordinated to a policy directed by the flow of goods. With a greater or smaller degree of promptness and frankness practically the whole world, in one form or another, after having withdrawn gold from circulation, suspended gold payments.

The danger of internal and external gold demands thus eliminated, the protection of high interest rates became unnecessary, and almost all belligerent countries embarked upon an era of government finance based upon low interest rates born of inflation.

This enabled the countries to procure the domestic goods and services needed at a cheap price for money, but at high prices for the things required; people imagining that they were escaping taxation when they were paying it in its most drastic and most inexorable form, by the depreciation of money.

The controlling and constraining power of gold once removed, there was no limit to inflation as long as any vestige of government credit remained. And on this basis there was, therefore, no limit to the domestic purchasing power of governments, and, consequently, no limit in sight to the rise of prices, once it was well started by precipitate and competitive government buying.

There was no limit on purchasing foreign goods (as far as they could be furnished and shipped and as far as they could not be paid for in services, goods or securities owned) except the willingness of the foreign seller either to grant individual or government credits in his own currency, or to convert his money into foreign balances or obligations, tempted by the low level of exchanges which naturally followed excessive foreign buying.

When foreign exchanges first began to decline to some points below their normal gold parities, a shiver ran down the spine of the financial community. Bankers and business men predicted that trade would stop and that the end would come if their exchanges were permitted to establish themselves at a substantial discount. But when prices for goods had risen by 100% and more, and when government printing presses, manufacturing a constantly increasing supply of money and credit, were paving the way for further rises, it was difficult to understand why the addition to cost of a few points, as involved in the initial fall of exchanges, should have had so far-reaching an effect upon trade. Subsequent events showed, indeed, that the flow of goods, at that stage, was hardly affected by this comparatively moderate increase in cost. The urgent demand for goods had overridden the gold tradition of the past and it overthrew with equal vigor and thoroughness the gospel of the inviolability of the gold parities of exchanges. As a matter of fact, this later development was nothing but a logical sequence; for countries had, in effect, surrendered their exchange parities at the very moment when they suspended gold payments.

It is true that for a while they struggled to preserve the traditional exchange levels. But with gold unavailable and with a shortage of exportable goods, the remaining means of defense could not long protect them. They could try, indeed, to draw money from the seller's country into their own, but that course was rendered difficult through the low money rates generally prevailing in their countries, as a consequence of the process of inflation applied for the purpose of facilitating government financing on easy terms. (Special rates allowed on foreign deposits were not capable of overcoming this obstacle to more than a moderate degree.) They could, furthermore, try to place their own government obligations in the creditor country's markets and payable in the creditor's currency. But that course could give only temporary relief, because the absorbing power for foreign loans, even in normal times, is, at best, only a limited one. It is even more restricted during a period when the savings of a country are unremittingly drawn upon for the purpose of meeting the home government's requirements, and when—the natural accumulation of investment funds not keeping pace with the government's demands—artificial measures become necessary in order to lead to success these home flotations, while the instruments of inflation are not made directly available for the benefit of foreign governments. In these circumstances, the only remaining avenue to follow was the direct placing of foreign loans with the creditor's govern ment. But, when the war emergency hac passed, that method became very unpopulai where a creditor country was already saturatec with its own government bonds and additiona issues involved further inflation of prices and increased annual burdens of taxation.

In such conditions, where the productive power of a country had been drastically reduced for an extended period, while its heavy demands for foreign goods remained unabated, it was inevitable that after a certain time of grace its foreign exchanges should sink to a heavy discount in countries with a fairly undisturbed productive power, so placed as to be able to furnish the goods. It was natural, however, that governments did not easily surrender to the slaughter of their exchanges. They tried to ward it off because they knew that, as long as the decline was moderate and as long as confidence still prevailed in an ultimate return to normal exchange levels, large foreign balances would be accumulated as a speculation for a rise, and that these, in themselves, would prove important factors in arresting the fall. If this decline exceeded certain bounds, they knew, on the other hand, that distrust would be aroused, causing not only such balances to be withdrawn, but opening the door to "bear speculations," resulting in a greater shrinkage than was warranted on strictly economic grounds.

If we place the cost of the war at $220,000,000,000, that would constitute an amount smaller than one-fourth of the estimated ante-bellum worth of belligerent countries. If we included the neutral countries, the proportion would be correspondingly reduced. In the United States it would amount to less than 10%. If we deduct our foreign loans, it would equal less than 5% of the estimated worth of our country.

But let us arbitrarily assume that it was as much as one-fifth of the value of the entire globe, we would have added 20% of "water" to the world balance sheet, while world prices have risen over 100% (and in many countries several times 100%). This extraordinary rise in prices is, therefore, not justified on the mere basis of direct money and credit inflation, but, to a large extent, it must be attributed to temporary disturbances, including decreased production. If we regain approximately our pre-war power of production, I believe that after a given number of years we shall look back upon our present period as one of excessively high prices for goods and excessively low prices for some rates of foreign exchange in countries expected to survive and to regain social and economic conditions approximating pre-war standards. That, in many cases, exchanges have declined too far may be established from a comparison of the respective cost of production of articles enjoying a world market.

If a Viennese and American factory turned out the same quantity of shoes and could sell them at the same price in Argentina, and if the Viennese factory, owing to the fall of exchange, could be bought for, let us say, half the cost of the American plant, there would be reason to believe that exchange had declined too far. One might ask: Why has not the price for the Austrian factory risen more? The answer is that adjustments of this character naturally take time and that millions of people, who lived on fixed income, are reduced to poverty; that if shoes in Austria rose too far the domestic sale would be too drastically reduced, and the home market is generally more important than the foreign field. Moreover, owing to shortage of raw material and disorganization of labor, quantities available for immediate export would not be sufficient materially to affect the world market for shoes or adequately to pay for the masses of material the country requires at once. These circumstances, together with other abnormal influences, may in certain cases bring about a temporary depreciation of foreign exchange rates far in excess of what economic conditions would warrant as a permanent basis, unless a country's complete economic collapse is to be expected.

If today we have reached a point where for many countries the old exchange parities have become a myth, have we any reason to be astonished? Is it not much more surprising that we should have expected any other result?

When countries had waived their obligation to settle their international gold obligations in

gold; when, in doing so, they had shaken o
the "straight jacket" with which the yello
metal had kept under restraint their issues o
currency and credit obligations; when, as
consequence, they had increased their govern
ment indebtedness in such a volume as to mak
it a very grave and puzzling problem for them
to raise the additional revenues necessary t
meet the increased interest charges; when gov
ernment credit thus impaired militated agains
the placing in foreign markets of some govern
ment securities while others, still enjoying a
good standing, encountered oversaturated markets because countries squandered their new paper prosperity in lavish extravagance instead of accumulating savings for investment; when, in these circumstances, decreased production and increased demand for goods had resulted in a general depreciation of money; when this depreciation varied, however, in the different countries from approximately 100% in one to 1000% in another (the review of Economic Statistics estimates that prices in Italy and France are now 3½ times, in the United Kingdom and Japan 2½ times, and in the United States and Canada over double the respective 1913 average prices); when some countries had fairly well arrested the process of inflation while others were still printing millions of currency and treasury bills to cover their daily deficiencies—what was there that could make us assume that the pre-war dollar was still equal to the pre-war Ruble, or Mark, or Lira, or Franc or Sterling? What, in the final analysis, had remained to determine the level of

exchanges but the flow of goods, and what remained to control and adjust the flow of goods except the exchange levels?

The discount at which the exchanges of some of the borrowing countries sold in some of the leading countries had to become so marked that it would prove for the borrowing nations not only an effective brake on unnecessary importations and extravagant consumption, but also a stimulus to greater productivity, by putting a premium on larger exportations. At the same time, an excessively low exchange rate would ultimately act as a powerful incentive for capital to flow, for temporary or permanent investment, into the markets affected.

With certain reservations, which it would lead too far here to specify, one might say that the premium, or discount, of foreign exchanges represents the differential tending to equalize the discrepancies in the price levels of things between countries of different degrees of inflation, productivity and credit. This differential is not the cause of the evil, nor the evil itself, as many appear to think; it is a necessary and wholesome factor of adjustment, a partial remedy—though, indeed, a painful one—but not the disease itself.

The belief is entertained by some that, as a solution of our difficulties, we are likely to abandon gold as the future means of ultimate settlement of international balances. I do not believe that the world will enjoy fairly stable standards of currency and credit until it returns to the observance of approximately the same principles of banking and finance as prevailed before the war.

That does not mean that I foresee that antebellum exchange parities will generally be re-established. Indeed, I hold the view that quite a number of countries will never regain their previous exchange levels. Their power to reclaim all or in part the shrinkage of their standards will depend upon their ability to produce and to save, and upon the measure of permanent depreciation sustained during the war, not only through a decrease of the value of their property, but also through the increase of their national indebtedness. But whatever the level they may be able to recover, ultimately it will be to their vital interest once more to fasten it to a definite gold relation and to reestablish a stable exchange, fluctuating between the maxima and minima of gold parities, without which a country's trade and growth will remain subject to a fatal handicap. (We may expect some countries to aim for a direct return to a free gold standard, while others may have to choose the indirect route of a gold exchange standard.)

But, it is claimed, there may not be gold enough to serve as a basis for the world's financial structure, particularly in view of the phenomenal increase in prices.

Time does not permit to dwell at length upon the question of the future trend of prices and to inquire whether we may not hope, in due course, to witness a substantial recession. Let us bear in mind, however, that the more perfect the machinery of credit, the more insignificant becomes the necessity of settling in actual gold. Where national credit, industrial enterprises and banking systems are established on a sound basis, adverse balances can be satisfied in many other ways than by payment in actual gold. *If government credits and commercial conditions are stabilized, we may confidently undertake the stabilization of exchanges with the existing gold supply. Unless government credits and commercial conditions are stabilized, we could not stabilize exchanges, even if an additional billion dollars of gold were poured into the world.*

And that indicates the road we shall have to follow if we wish to wend our way out of the present labyrinth. *We are living in an era where the production of money and credit has increased and the production of goods has decreased. In order to emerge we must produce less credit and money and produce more goods.*

In practically all leading countries the people have been urged in the strongest possible manner to produce more and to consume less. I believe it is safe to say that this appeal to voluntary action on the part of the individual has universally failed. Extravagance will not be curbed and the increase in prices will be arrested, not by moral suasion, but only through the effective pressure of necessity.

If governments adopt a rigid policy of preventing the further issue of government securities and money for the purpose of covering current deficiencies, they will take the first and most effective step in combating the decrease of production, the rise of prices and the fall of exchanges. If they will not, or cannot, adopt such a course, they are headed for insolvency and social and economic disruption.

Where gold payments have been suspended and foreign exchanges have become demoralized, *the restraining influence once wielded by gold must be exercised at this stage by rigid budgets.* When, by curtailing expenditure and by increasing current revenues, the issue of government loans to cover current deficiencies has come to a stop, when the floating supply of undigested government securities has gradually been absorbed, the time will again be ripe for an effective control of money markets by the central banks. And when central bank rates are thus once more effective and the foreign credit of a country has been restored, the moment will be at hand when the resumption of gold payments may be considered, and with that the stabilization of foreign exchanges. Whenever that point is reached, a country may be deemed to have completed its economic convalescence. The first step in this direction must be the establishment of honestly balanced budgets.

A country's ability, without additional borrowing, to balance its regular budget, is the test of its solvency. The character of this test at this juncture will decide the measure of its future credit; and upon that, in turn, will largely depend its power to rehabilitate its commerce and trade and its foreign exchanges.

Side by side, however, with the determination of the government to stop the further increase of government debt, must go an equally firm policy on the part of the note-issuing banks to arrest a further expansion of circulation.

It was the excessive, though unavoidable, issue of government securities that destroyed the sound understructure of note issues based upon commercial paper and gold. Directly or indirectly government treasury bills became the main asset of leading central banks, crowding into unimportance commercial paper and gold reserves.

As we review this cause and course of the evil, we gain a clear perception of the remedy. *As the harm was done through excessive issues of government securities, so the cure lies in arresting and, if possible, retracing that course.* Governments, through a sound budget policy, must stop as fast and as far as possible the increase of their securities, and where a gradual amortization is not practicable, they must, in conjunction with the central banks, embark at least upon a policy compelling a distribution of the floating material—of bonds and treasury bills—driving them away from the central banks and commercial banks into the hands of the investors. This may involve higher levels of interest rates for both commercial paper and treasury bills, but in the long run it would prove a lower price for the country to pay than the undisturbed display of forces making for a continued area of rising prices and social and economic unrest. Unwillingness on the part of central banks further to increase their investments—or their desire, if at all possible, to reduce their holdings—accompanied by curtailment of extravagance on the part of the governments, is bound to bring about contraction of loans and a tendency toward falling prices. Moreover, a movement in this direction would be furthered through the increased taxation necessary in order to accomplish the contemplated increase of government revenues.

It is essential, however, that taxation be so devised as to curb extravagance. Our present form of taxation has proved a failure in so far as in a rising market the equivalent of extreme income and profit taxes is being added to the price the public pays for things, and in so far as it cripples the investment power of a country and thereby retards its further development.

Through the depreciation of the purchasing power of money the value of the return from investments (that is, from savings of the past) has been cut in two in countries with the soundest economic conditions, and in those most adversely affected it has been decimated, if not practically wiped out. The distribution of income in all countries has, therefore, been drastically modified. In the aggregate the share of the farmer and the wage earner has been phenomenally increased, at the expense of those who lived on fixed income from savings of the past. Extravagance must not only be curbed on top, but just as much on the part of the masses receiving the bulk of the national income and, in the aggregate, doing the largest share of the country's spending. Taxes that, on a rising scale, are laid on spending, not on saving, and effective consumption taxes that make for lower price levels and enrich the government (and not the producer, wholesaler or retailer), will, I believe, be the logical outcome of sensible and conscientious budgeting.

The world, as a whole, has, since the beginning of the war, been living in what business language would term a "seller's market"; it must be turned into a "buyer's market" if we are to perfect a cure. In other words, goods must seek the market more eagerly than the market seeks the goods. It is only in this manner that the "flow of goods" may again become subjected to a policy directed by the "flow of gold"!

I am painfully aware of the fact that this exposition of the problem has been an unduly severe strain upon your patience, but the conclusions, to my mind, are simple and would not be as puzzling, as apparently they are for many, if the causes of the disturbance were generally more carefully analyzed and better understood.

The debacle of foreign exchanges is the logical consequence of the financial anarchy prevailing since "King Gold" was deposed.

The discount of the foreign exchanges of borrowing countries is not the disease, but the symptom. It expresses the differential between various degrees of depreciation of money and credit, and between dissimilar grades of productivity, in different countries.

When the equalizing power of gold, interest rates and government credit has spent itself, the discount of foreign exchanges acts as the only remaining means of adjustment.

Foreign exchanges of the countries affected cannot be stabilized until their importations and exportations more nearly balance one another and until the process of dilution of currency and government credit is uniformly reduced, or arrested.

Rigidly balanced budgets are, therefore, required, because they restore the public credit; because they arrest further inflation; because they lead to curtailment of expenditures and increased taxation—which, if properly devised, makes for decreased consumption, increased production and lower prices. And these, in turn, are essential in that they stimulate exportations and discourage unessential importations, and thereby bring about the possibility of more nearly balancing the two.

For years to come the rehabilitation of currency standards and foreign exchange levels of borrowing countries will depend primarily upon the fiscal policy of their governments; it will be the character of their budget (including, as it does, the question of labor and increased production) that, more than anything else, will decide their future economic worth and development.

If we agreed on these premises it is obvious why it would be foolish to think that in times like the present foreign exchanges could or should have been permanently "pegged."

Unless the flow of goods, or the issue of treasury bills and currency in payment of deficiencies, could have been arrested in borrowing countries, no lending country could have granted or absorbed loans large enough to keep on an artificial basis of parity things that intrinsically had become so dissimilar in value. Moreover, indiscriminately to grant such loans would have been an unwise and uncharitable policy for all parties concerned; because it would have pushed nearer the precipice both debtor and creditor country instead of leading them, in the opposite direction, towards gradual recuperation.

For the vast number of American consumers, a recession of prices is of infinitely greater importance than boosted exports sold at high prices to purchasers whose natural limit of credit has been fairly exhausted.

For foreign countries buying our goods a decline in our prices would mean either a corresponding drop in their own prices or a recovery in their exchanges, or a combination of both. In any case, we would serve them better if we sold them at a lower price the minimum that they must have, than if we furnished them on credit and at high prices the maximum they might take.

After five years of suffering and sacrifices the masses at present are unruly, self-willed and unreasonable. They are unwilling to submit to irksome government interference or drastic burdens of taxation. The lending countries, by insisting on the adoption of a balanced budget policy on the part of borrowing countries asking for new loans, and by reducing such credits to the very minimum necessary, would assist their debtors to choose a safe course, which, without such outside influence, their governments might not always be able to follow.

In formulating these general principles and observations one cannot, of course, be unmindful of the fact that there are certain emergencies involving the danger of so much physical and economic suffering that, from the point of view of altruism and enlightened self-interest, prompt relief would seem imperative. Where, without outside assistance, reconstruction is beyond the grasp of a people, or where it is facing starvation or economic annihilation, there cannot be any doubt that we must do our full share in bringing relief, be it through private initiative or, if need be, through direct or indirect government action.

Except where plainly altruistic motives must thus exercise a determining influence, I believe that the time is near at hand when international bankers, considering new loans, will apply the strictest principles, not only with respect to budgeting, but also with regard to the urgency of applications and the purposes involved. As it will be every citizen's patriotic duty to accumulate savings, so the aggregate gathered for investment will have to be looked upon as a sacred fund belonging to the nation, to be employed only where it will do the greatest possible good. World demands in the near future will far outdistance world savings and—if it were possible—nothing would be more timely than a "world priority list" regulating the use of new capital. These views, I fear, do not sound very encouraging to countries of our hemisphere whose future largely depends upon new development. Happily, however, several of them are in the class of lending rather than borrowing countries, and quite a number, through the emergencies of the war, have been taught to develop their resources and new industries and have made admirable progress in the direction of greater economic and financial independence.

My own belief is that capital in the old world will find so vast a field in work of reconstruction and colonization in "darkest Europe" that it will not be able to devote itself as liberally to the development of the countries of this hemisphere as it did in the past. The three Americas will, therefore, be drawn together in a commercial and financial union of growing strength and intimacy.

The aftermath of war finance must be cleared up before countries may return to a pre-war attitude towards business. I believe that the United States is moving faster in this direction than almost any other country. According to the statement of the Secretary of the Treasury we have stopped increasing our public debt and have begun reducing it. We must persist in this policy and now bend our efforts towards arresting and breaking the rise of prices; towards compelling greater industry and thrift; and towards distributing our undigested war obligations. It is very possible that, in order to accomplish these aims, and to free ourselves from the last vestige of hot-house financing, we may temporarily have to submit to a period of liberal interest rates for both treasury and commercial bills. While the immediate future, therefore, may not look bright, with a view to foreign financing on easy terms, we shall be all the stronger after we shall have gone through this process of purification, which will be the shorter and the easier the earlier we earnestly undertake it. We can now safely embark upon it without fear of a crash, while the problem might prove graver if we indulged in a policy of continued inflation and prosperity based on a further rise of prices.

If we keep our heads cool and act wisely, if we deal with our problems, not from the narrow aspect of what serves best the single individual or single country, but from the broad point of view of what, at this critical juncture in the history of the world, is the course that is best for all, we shall be able to do our full share not only in the reconstruction and rejuvenation of Europe, but also in developing the intimate trade relations which, as a matter of logic and sentiment, must link together the sister republics of the three Americas.