Foreign Exchange Control 1931-1940

by

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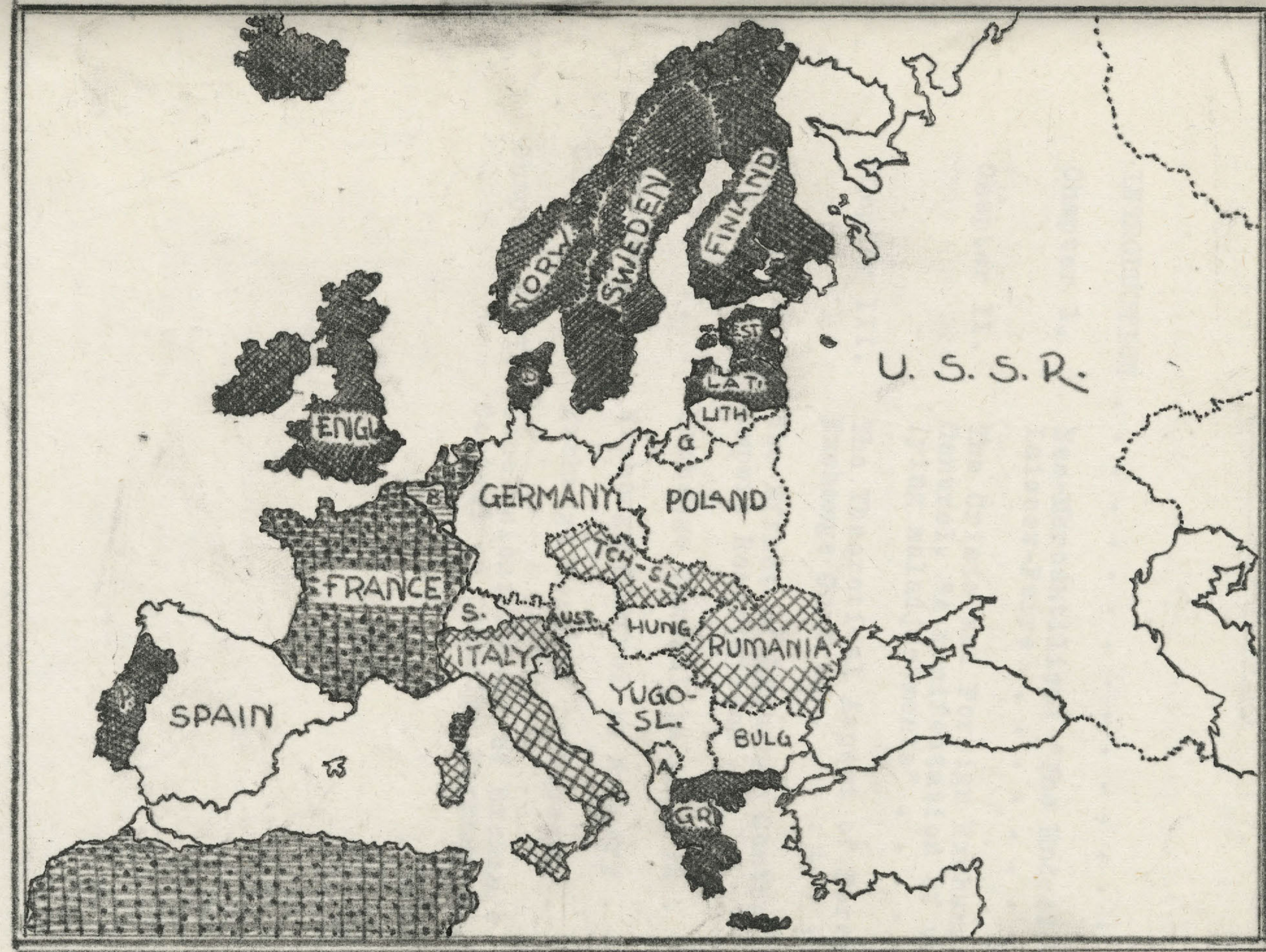

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INTRODUCTION.

The analytical approach to foreign exchange control can take one of two consistent forms. The technique can be explored in relation to the absolute criterion of international specialization or, it can be examined in relation to the relative criterion of national expediency. However, it is impossible to deal with the subject consistently if we accept the relative premise and apply the absolute criterion to it.[1] When the authoritanian powers chose full employment as their goal instead of international price and exchange equilibrium, it is fruitless to prove that they failed in something which was not their goal. Their aim may have been incompatible with global peace and prosperity but that is irrelevant to the proposition.

This works purports to examine (1) whether exchange control is a technique in a secular trend or, merely an emergency measure; (2) are its characteristics universal or

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1. (a) League of Nations, "Report on Exchange Control," (Geneva 1938). This report falls into a labyrinth of errors on account of this fallacy; pp. 34 et seq. Once exchange control is accepted to be an outgrowth of inherent political and economic maladjustments it is difficult to see how we can speak of its removal while these maladjustments still exist.
   (b) Heuser, Heinrich, Control of International Trade, (London 1939). Although this is a much more scientific work, the author also seems guilty of this misdemeanour; pp. 174.
   (c) Howard S. Ellis, Exchange Control in Central Europe, (N.Y. 1941). This work is least guilty of all on this point. Nevertheless the distinction between the two criteria is not made and their relation remains ambiguous; pp. 309 et seq.

specific to the economy in which it exists; (3) has it performed its functions[2] adequately in recent applications, (1931-1940); (4) what are its potentialities as an institution in future world economy; and (5) what impact will it have upon Canadian economy.

The student in residence who attempts to do any intensive research on European economy is necessarily hampered by his inability to use all the primary sources. In addition to this, the scope of this study has been, for the time being, voluntarily restricted in the interests of space and time. No attempt is made to explore the political tenets of National Socialism or the ethical problems involved in the existence of a dictatorial regime. The aim of this thesis has been to approach the study of economic conditions in contemporary Germany and the Continent from an impartial and objective standpoint.

The conclusions reached in the first four chapters must be qualified by the use of secondary sources and the conglomeration of other factors[3] which belie the success or failure of the technique itself.

In the Canadian-American situation the authorities do not find it advisable to offer all the pertinent information. We have therefore been obliged to use less authoritative indices and refrain from making any vulnerable long-term generalizations.

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2. The functions of exchange control will be enumerated in chapter 2.

3. Quotas, tariffs, price controls, etc.

Neo-Mercantilism: "The End of Laissez-Faire"[1]

John Maynard Keynes

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[1] John Maynard Keynes, "The End of Laissez-Faire," London, 1921.

CHAPTER I

Prior to the Neo-mercantilist Kondratieff of (1897-)[2] there was a plurality of interdependent sovereign states, on the whole, complementary to one another. Each state had its own monetary system and its own monetary authorities who decided what policies to adopt and how they would be carried out. The choice of policies was a function of the choice of aims and the choice of means. Monetary policy was, of course, an instrument of economic policy in general, and depended upon the principles of the State and its anticipations as regards peace or war. This "bourgeois" Kondratieff of 1843-1897 was a relatively quiescent one. Different national monetary policies were directed towards the creation of conditions under which a lasting equilibrium in balances of international payments was maintained. The stable exchange rates were pre-requisite for smooth foreign trade and long term capital investment, since they were a <u>symbol</u> of those deeper factors which create stability of international economic relations.

The transactions[3] which give rise to payments from country to country belong to one of three main groups: (1)trade in commodities and services; (2) long term capital movements (including the debt service and dividend payments); (3) movements of short term funds. As Angell has said, the balance

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2 Schumpeter, "Business Cycles," 1939, p.397,etc.

3 The less important items, such as immigrants' remittances, are not important for the present analysis.

of international payments of a country is in equilibrium if "the net balance of the aggregated commodity service, interest and dividend, and long term capital operations, so far as these operations entail actual international payments...is zero."[4] The conditions required for such a long-run equilibrium are:

(1) Relatively great freedom of trade, or at least great stability in tariff structures and absence of quantitative restrictions;

(2) Flexibility of national price and income structures;

(3) Stability in the international flow of capital;

(4) Absence of large and sudden displacements of short term funds. This item includes interbank credit, transfers of deposits, purchase of foreign bills of exchange; purchase of foreign-treasury bills, commercial credits, purchase of securities in a foreign market with the expectation of their early re-sale abroad, etc.

The long term capital movements, unless they are cancelled out by capital movements in the opposite direction, give rise either to an increase in trade, or to deposits of short term funds of the sort mentioned above. The latter are also used in the end for the purchase of commodities and services unless they constitute a reserve for meeting future payment arising out of the debt-service.

Whenever a disruption of equilibrium occurs, it can only be re-established by changes in the capital and current account, and the gold standard at that time provided an excellent

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[4] James W.Angell: "Equilibrium in International Payments, in Exploration in Economics." Notes and Essays contributed in honour of F.W.Taussig, N.Y., 1937, p.17.

mechanism for making the necessary adjustments. This was possible because the conditions enumerated prevailed. It is important to note that the long run definition does not contain any reference to short term movements of funds. The proper function of these movements is to make other adjustments easier and smoother; as a long run phenomenon they should cancel out. It is only when they are very great and spontaneous that they become an unbalancing factor.

When a country is faced with a passive balance on the current account, which is not compensated by long-term capital lending, the monetary stock of that country should diminish and that of her trading partners should increase.[5] The deflationary trend in the country of excess imports was, prior to our 1897 norm, accompanied by a rise in the money market rate of interest which percolated through the open and central markets.[6] Short term funds flowed in and rendered the final adjustment slower and smoother. The extent of this cushioning effect, however, still awaits its historian. Nevertheless, Dr.Viner is undoubtedly correct when he states that"the role of short-term capital movement as an equilibrating factor is limited..by the imperfect international mobility of such funds."[7] These transfers of funds take place for one of two reasons: either to obtain a higher rate of interest than their owners can get at home; or to guarantee them against any depreciation that might take place because of monetary

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5 cf.Von Hayek:"Monetary Nationalism and International Stability", London, 1937.

6 Schumpeter, op.cit., p.612. (N.Y.1937),

7 Jacob Viner, "Studies in the Theory of International Trade." p.405. Minn.,

regulations anticipated at home, or for fear of inflation, etc. That is, international movements of short term funds take place: mainly in search either for greater returns or for greater security. The former type of movement has an equilibrating effect upon the balance of payments. The latter, which will be discussed later and is of utmost importance in the history of exchange control, has an essentially unsettling effect.

When laissez-faire reigned supreme, the volume of short term funds was largely directed by consideration of larger return and not of comparative safety. The reason for the existence of large short term funds is to be found in the fact that lack of confidence diminishes willingness to invest abroad or even at home on long term. Thus a great fund may be accumulated, which, pending the revival of confidence - when it will be put into investment - remains on current accounts in financial institutions and gets transferred from country to country according to the appreciation of their comparative political and economic security. As we shall see, during the present Kondratieff this factor has played an important part in the disintegration of international monetary relations, while in the "good old days" it was not a factor at all.

London was the centre of a great free trade area. Commingled with the fact that she was the banker of the world, international, economic, financial, and monetary collaboration was organized around her. The pre-war gold standard flourished, although to some extent it was a managed currency. "The international gold standard supplies the world with a mechanism for maintaining fixity of exchange and for keeping in organic touch with one another the price and income structures of the various countries. But the degree to which the second of these functions is in fact adequately performed depends, not on the mere existence of a common currency basis, but on the manner in which the detailed administration of the gold standard in each and all of the countries adhering to it is carried out."[8] The important thing before the war was that the different gold standard countries carried out a policy which aimed at the maintenance of that system; national policies were co-ordinated through that common objective and through the general acceptance of the same fundamental principles of monetary policy. Thus the gold standard working in a world of political stability where trade was relatively free and capital movements relatively stable was a successful achievement of monetary internationalism.

The social atmosphere began to change in the late nineties and Schumpeter proclaims 1897 the symbolic year of a changing attitude toward capitalism.[9] Electricity was the predominant invention of the third Kondratieff. It revolutionized the relative economic position of nations, and altered the trend of foreign trade. The conditions necessary for monetary internationalism began to wane. Protection increased,[10] expenditures on armaments loomed and the ominous rumblings of war cast a black shadow on the structure of financial relations. "However much the war - and the

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8 T.E.Gregory:"The Gold Standard and Its Future." London,1932,p.21. Also Leo Pasvolsky, "The Necessity for a Stable International Monetary Standard", International Chamber of Commerce, Paris, pp.17-18. Our italics.

9 Schumpeter, op.cit., pp.398-399.

10 In England this was a mere lobbying in that direction, while the Dingley tariff of 1897 in the U.S. meant a victory of a tendency that was long prevalent.

circumstances of the 'Have-not nations' - may have had to do with concrete forms...and surface events, that departure from the road that leads from capitalism to orthodox socialism is not "due" to it, and the general drift..might have been the same had it never occurred."[11] The World War I merely removed the lid of the fermenting trend.

What Secretary Morgenthau called the "streamlined gold standard" of the post-war era was a great edifice built on quick-sands. Economic Nationalism became more pronounced; confidence was never recovered; international conferences followed one another at an increasing rate, but the spirit of cooperation, the willingness to sacrifice immediate advantage to a more distant common good were absent in all concerned.[12] No artifice of monetary technique can replace confidence that is missing. Before constructing technically perfected monetary systems, it is necessary to create conditions in which those systems can live and prosper. Those conditions were never restored. Monetary internationalism became a camouflaged, decentralized financial system.[13] Barriers to trade went on growing throughout the post-war period in spite of resolutions adopted to the contrary by various conferences. The industrialization of agricultural countries and the re-agrarianisation of industrial countries progressed considerably. Both were due, to some extent at least, to the incomplement-

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11 Schumpeter, op.cit., p.697.

12 James, F.Cyril, "Economics of Money, Credit and Banking," N.Y.1490, Chapter 34.

13 The most recent and comprehensive book on this subject is by A.Brown, Jr., "The International Gold Standard Reinterpreted," 1914-1934,(N.Y.) 1941. cf.Book III, part III.

arity of microbe political states, to the feeling of political uncertainty and to the anticipation of a possible new war. Here we faced the unsolved problem of political myths versus economic realities. The World Economic Conference voiced much alarm on account of these tendencies but the resolutions adopted remained a dead letter. If international trade expanded, nevertheless, this was mainly due to a great international credit expansion practised particularly by the United States. While the effects of growing economic nationalism were thus, for a time, covered with a thick veil, maladjustments were increasing underneath. Credit expansion not only allowed the United States to maintain an excess of <u>exports</u> over imports, (while accumulating a great capital investment abroad); it also gave Germany the means to meet reparations payments and have a surplus left over. This made it possible for Germany to have a "de facto creditor position," while accumulating a large debt. Similarly, the exporting agricultural debtor countries borrowed heavily from abroad. Payments for industrial purchases were commensurate with their staple exports and no surplus was accumulated. This meant that they were able to "balance" their international accounts by going deeper into debt.[14] Germany was thus able to avoid making the impossible adjustments in costs and in the structure of production that would allow her to obtain the export surplus which she would have needed in the absence of American loans. And the other debtor countries were incurring liabilities out of all proportion to their ability

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[14] V.Timoshenko: "<u>World Agriculture and the Depression</u>."
1928: Canada, Argentina, and Australia had an <u>active</u> trade balance of $124,000,000.
1929: net <u>debit</u> $484,000,000. As no more loans were forthcoming, they were compelled to curtail imports and force exports if international payments were to be made.

to pay. Sooner or later these maladjustments had to come to the fore. The maldistribution of gold was much discussed, but this was an <u>effect</u> more than a cause of trade dislocation. The scarcity delirium of the yellow metal introduced the gold-exchange standard: the antimony of an <u>international</u> monetary "system" parallel with economic nationalism. The rationalization of industry was accompanied by cartels and monopolies on one side and the growth of trade unions on the other. Both had the effect of producing rigidities in the price and income structure. Capitalism became more and more "trustified". Neither is it very profitabe, nor instructive to blame politics on all our institutional ills, (although there can be no doubt that it played a very important role in post-war events). "Taking the social system of capitalism as a whole, it is meaningless to say that it - or any element of it, e.g. the gold standard - is checkmated by "politics." What ought to be said - on this level of analysis - is that it checkmates itself."[15]

Protectionism; unwillingness to lose gold; unequal depreciation of currencies; instability in long term capital movement; large and erratic invasions of short term funds looking for safety; these were the main characteristics which contributed to the collapse of monetary internationalism. The United States' "refusal to accept her creditor position" has been the scapegoat for most laissez-faire ills.[16]

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[15] Schumpeter, <u>op.cit.</u>, p.698.

[16] J.P.Day, "<u>An Introduction to World Economic History</u>". "The Hawley-Smoot tariff was the prime cause of the loss of the Geneva battle for freer trade." p.89.(London, 1939).

Although her inexperience as a creditor nation undoubtedly led to a myopia of foreign lending,(i) it must not be forgotten that the United States became greatly industrialized during and after the war. She competed in the East and even in Europe with Great Britain, France and Germany. There was therefore a likelihood that the cost structure precluded the influx of many industrialized goods. Had a reduction of import duties been passed instead of the Hawley-Smoot Act, it is difficult to see how this could have improved short-run conditions in Europe without aggravating them in America.(16a)

England's unfortunate experience over the stabilisation of the pound in 1925 contributed very largely to an urgent controversy; namely the relative importance for the economy of a country of internal equilibrium as compared with external equilibrium. The former meant stability of internal prices, the latter, stability of foreign exchanges. With a view to restoring London's financial supremacy(17), England

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i. Total short term loans to Germany in 1927 were equal to 2,264 million RM. In 1930 these loans dwindled to 167 million RM. The United States was the predominant creditor. League of Nations, "Balance of Payments 1937", (Geneva 1938); pp. 108.

16a. Paul Einzig, The Exchange and Clearing System, (London 1935). Einzig, as usual, exaggerates this trend since marginal trade could even take place in many of these goods, and if not, there was no reason for the tariff at all on such commodities.

17. Paul Einzig, The Struggle for Financial Supremacy. (London 1931)

returned to the gold standard at a 10 per cent pre-war overvalued £ rate. This imposed the necessity of deflation so as to reduce gold prices to a level on which British export industries would become again competitive on the world market. The deflation proved, however, extremely difficult to carry through on account of rigidities in the price structure and particularly in the level of wages. What is even more important, the niches of vested interests, including both capital and labor, sabotaged capitalism. Without a coherent plan for the rationalization and scrapping of obsolete industry, England's exporttrade became decrepid. The fact that too high a parity imposed a deflationary strain upon the country and, as the deflation did not succeed, resulted in a loss of export trade. This has contributed very widely to spreading the idea that all maladjustments between domestic and foreign prices can be secured by a process of devaluation. It did so even more when the devaluation of the pound in 1931 and the formation of a "sterling area" resulted in a great improvement of England's economic conditions.

The dilemma "deflation versus devaluation" probably finds its roots in the British experience of 1925-1932; its success is due to the development of monatary nationalism and neo-mercantilism. The essential difference between nationalism and internationalism lies in the conception of the relative importance of a country as compared with the world at large.

Internationalism situates a country within the framework of a collectivity of interdependent though politically sovereign states; it looks for the solution of an individual country's problems within the network of international relations. Such is not the case in nationalism for which a country stands supreme and foreign relations are usually impediments. Deflation, devaluation when considered as two horns of a dilemma are policies determined by purely, although perhaps necessary, national motives. From an international point of view one may find that neither of them is a solution - particularly when the problem to be solved is found essentially in the disorganization and incompatibility of international relations. Prior to the crisis, all the prerequisites of monetary internationalism were lacking and the development of neo-mercantilism was a consequence of abandoning the idea of rebuilding international economic and political relations on a stable foundation. This, in turn, was the result of the decline of liberal capitalism and the general development of nationalism in the world.

To tell us that "under more normal conditions .... it will probably be found that the dilemma between the aims of external and monetary stability is more apparent than real, and that it arises very largely out of a too literal acceptance of the abstractions of gold standard theory", may be perfectly true but not very pertinent to an abnormal crisis.(18)

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18. Prof. John H. Williams: quoted from "The World's Monetary Dilemma", Proceedings of the Academy of Political Science, April 1934, pp. 65.

The Crisis and Foreign Exchange Control

"A manifestation of underlying maladjustments"

CHAPTER II

The decade prior to the summer and autumn of 1931 witnessed three major economic changes which called forth a mew technique in the general sweep of étatisation. The aims of external monetary stability became more onerous upon the debtor economies. 1) The astonishing achievements of science in the domain of agriculture, coupled with the general trend towards autarchy, resulted in a greater fall in the prices of "simpler foodstuffs" relative to the general decline of values during the depression which had begun at the end of the year 1929. The result of this fact upon agricultural exporting countries whose industrial imports were to be paid out of already depleted devisen reserves is self-evident. 2) The decrease of capital movements to Central and Eastern Europe and the sudden withdrawal of foreign credits, combined with an expatriation of national funds, from the same group of countries aggravated the secular price trend in the poorer countries and began to play havoc with the exchanges. 3) The depreciation of sterling made exports to that country more difficult and further deflationary trends were forced upon these countries who could least bear it. The panicky flight of frozen and domestic capital after the Credit Anstalt affair threatened to exhaust the gold and devisen reserves of the European and South American debtor countries, and therefore to endanger seriously the maintenance of currency stability. Had there been a greater scrutiny over the American monetary machine between 1925-29 these sudden short-term withdrawals may have been precluded. Heuser claims that "it was this major change, before and during the depression, which caused the introduction of exchange control, in a desperate effort to stem the tide of the demand for foreign means of payment."(19) The important thing to the investigator is that these immediate factors were the consummation of the underlying maladjustment of the post-war decade. The technique of foreign exchange control was merely another weapon of neo-mercantilism whereby the national state extends its influence from the internal to the international sphere. Given the strife for autarchy, the political and even economic impossibility of making the necessary adjustments to the great and sudden changes that were taking place in the structure of international payments and the underlying modern monetary nationalism, it would have been indeed little short of the ridiculous to trust to the remedial forces of laissez-faire. Prices and/or exchanges had to be controlled.

With several qualifications, Mr. Keynes states the choice between stable internal prices and stable exchange rates fairly. "Since ..... the rate of exchange of a country's currency with the currency of the world (assuming for the sake of simplicity that there is only one external currency) depends on the relation between the internal price level and the external price level, it follows that the exchange cannot be

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19. Heuser, op.cit., pp. 4.

stable unless both internal and external price levels remain stable. If, therefore, the external price level lies outside our control, we must submit either to our own price level or to our exchange being pulled about by external influences. If the external price level is unstable we cannot keep both our own price level and our exchanges stable. And we are compelled to choose."[20] Before discussing the evolution of this thesis in relation to foreign exchange control, several inexactitudes must be noted. 1) The assimilation of all foreign countries to one single currency is a misleading simplification. 2) There are no price levels in the real world but only price structures and while international comparisons between changes in national price structures are more difficult than comparisons between price levels they are much more instructive and provide a safer basis for policy. Lastly, the notion of external influence upon a national economic situation is often used in defiance of the fact that a national economy is linked by more than one tie with other national economies. The transition from the notion of "external influences" to that of an "independent national economy" is one of degree only.

Governments, in the past, generally chose to stabilize either the price level or the rates of foreign exchange. These two lines of policy were compatible with one another

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20. J.M. Keynes, A Tract on Monetary Reform, (London 1923), pp. 154. (Reprinted in "Essays in Persuasion" London 1931, pp. 195)

only if foreign countries also follow a policy of stabilising the price level[20a] - that is to say, only by international co-operation. But if in foreign countries the price level is rising or falling, a liberal economy in question is faced with the dilemma of either stabilising the exchange rate and letting the domestic price level move in sympathy with the foreign price level, or stabilising domestic prices and allowing the exchange rate to move in inverse ratio to the movement of the foreign price level. By and large, stabilisation of the exchange rate is the line of least resistance, unless price levels abroad are moving in the inverse direction. Fluctuations in the exchange rate leap to the eye whereas small changes in the price level are less clear-cut and attract less attention. In financially weak countries, particularly where the memory of inflation is still fresh - every deviation of the exchange from gold parity or even any likelihood of such deviation must lead to a crisis of confidence and to withdrawals of credit.

For smaller countries in whose economic system foreign trade plays a large part, stabilisation of the exchange was the only possible policy. Particularly if they were dependent on foreign capital, they were forced to sacrifice stability

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20a $R = \frac{Pa}{Pb.K.}$

K, therefore, must remain constant, for if K changes, the exchange and the price-level can both remain constant only if the price level abroad happens to have shifted exactly parallel with K.

of prices to stability of the exchange, at any rate so long as there remained important countries abroad with a fairly stable monetary system to which they could attach themselves. For strong countries there was another way out. As we have seen, Mr. Keynes advocated for England a policy of stabilising the price level with the aim of smoothing out cyclical fluctuations, even at the cost of an unstable exchange rate with the gold standard countries.

Since September 1931 Britain has largely followed this policy of price stabilisation. This enabled the Scandinavian countries and the Dominions to reap the advantages of stable exchange rates with England and with other members of the sterling group, and to maintain stability of prices with one another.

The instability of the exchange rate between the gold and the sterling currencies led to serious disadvantages. Haberler is undoubtedly correct when he concludes that "an international standard of one form or other, is indispensable in the long run for an extensive exchange of goods and credit for an individualistic basis."(i) Once that basis has collapsed a rigid control of the capital market becomes inevitable. Exchange control promised <u>both</u> a camouflaged stability in exchange rates and the insulation of national economies from external depression tendencies.

(i) Haberler, <u>Theory of International Trade</u>, (London, 1936) Section on Exchange Control

Germany witnessed a pronounced boom in 1928-29. This expansion was largely financed by imports of foreign capital, of which more than half[21] were short-term credits. The latter were not subject to the profit tax and the stringent money market kept the average rate of interest on bank loans at the onerous level of 10.2 per cent.[22] It is therefore not very surprising that the average American speculator poured his funds into German industrial reconstruction. Resources of the short-term capital market were also strained by public housing expenditures, while the supply of foreign credits had been curtailed by the counter attractions of the New York Stock Exchange.[23] The Dawes annuities had reached their maximum of 2,500 million RM. This too had a dampening effect upon the economy. In November 1929, the inflated securities on the New York market (whose prices had no relationship to yield) fizzled. This hurricane that blew from New York in the autumn of 1929 swept over Germany with deadly force and it was apparent to everyone that the stage was set for an economic depression.

The collapse of the Austrian Credit Anstalt in May, 1931 sent a wave of panic over the financial world. Germany was already in a state of rapid economic contraction and political disintegration. The volume of production had shrunk

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21. C.W. Guillebaud, The Economic Recovery of Germany 1933-38. (1940); pp. 8. London.
22. Ibid, pp. 8.
23. Private investments in new fixed capital from 1924 to 1929 = 10.4 milliard RM. Investments of public bodies amounted to 24.2 milliard RM. (the bulk of the latter took place in 1927 to 1929); ibid, pp. 14.

from 100.2 (1928 = 100) in September, 1929 to 82.5 in December, 1930;(24) unemployment had risen from 1,324,000 to a peak in February, 1931, of 5,000,000. Bills discounted, sight deposits of the Reichsbank and money order transfers shrank on the average 25.4 per cent. Monopoly prices, both in the field of commodities and labor, greatly intensified the depression.

Wage rates,(index of wages determined by collective bargaining)stood at 105.5 (1928 = 100) in 1929 actually rose in 1930 to 107.3 and declined only slightly to 102.1 in 1931.(25) These wage rates of collective contracts, as usual, were very illusory, because of sporadic employment, lay-offs, and numerous evasions. But in view of the great increase in unemployment, the decline in aggregate labor income seems very small:

1928 - 42,621,000 RM
1929 - 43,045,000 RM
1930 - 39,600,000 RM

Industry demanded a drop in wage rates to reduce costs and prices, while labor argued that price reductions should predede wage reductions in order to preserve effective purchasing power.(26) When the struggle between labor and capital faces the division of a shrinking national dividend the rigidities in our system become even greater entrenched.

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24. V.z.K., Vol. 7, Part A, No. I, pp. 264 - quoted by Ellis, op.cit., pp. 159.
25. Ibid, pp. 30.
26. Jahrbuch 1930, (Berlin 1931) pp. 9. As we shall see, it seems that Mr. Keynes' thesis was vindicated by fact. Following the Brüning deflationary decrees of December 8th, 1931, reductions in money wages did not result in reductions in real wages, or in lower wage costs relative to the value of output. Cf. J.M. Keynes, G.T. of Emp. I. & M.Chapt. 19.

Nearly all parties agreed that a balanced budget was desirable. Labor insisted that it be achieved by increased taxation upon the propertied classes and even to cover the additional load of unemployment benefits and public works; capital clamored for lower wages.

In the Spring of 1930 the Müller government was overthrown. All the public work policies were dejected and a balanced budget was the platform of the new Chancellor. The Heinrich Brüning government held a precarious position as a minority party relying upon the votes of the Social Democrats. In July the Socialists voted against the government's reconstruction program, whereupon the Reichstag was dissolved and the program came into force by the Emergency Decree of July 26th, 1930. A general malaise spread over the German Nation and the deflationary spiral set in.

The election of September 1930 revealed the devastating effects of depression upon the German internal politics. National Socialists and Communists showed large gains in the Reichstag, the former from 12 to 107 seats.(27) Brüning remained in office virtually eliminating the Reichstag. The Social Democrats were caught between the upper and nether millstones of National Socialism and Communism. They too passively tolerated the government. The tense situation shook internal confidence and led to flight of German capital abroad.

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27. Ellis, op.cit., pp. 162.

It was only due to a rise in the Reichsbank discount rate from 4 to 5 per cent[75] and the Lee Higginson loan of $ 125,000,000 from America that the outflow was checked. But in the meanwhile the Reichsbank had lost 800,000,000 RM in gold and foreign exchange holdings[76] within a single month and by December 11th, something over double this sum. A new budget deficit accumulated shortly after the election and it was only by virtue of 400,000,000 RM issue of Treasury Bills that the difficulty could be tided over.

The next few months saw creditors alert and uneasy. On March 19th, 1931, came the very ill-timed proposal for a customs union of Germany and Austria.[77] This move was bitterly opposed by the French who withdrew considerable funds from Germany as a means of applying political pressure. The Credit Anstalt affair, two months later, was the knockout blow to the already shaken belief in the stability of the post-war economic "reconstruction" of Europe. From the end of May to the middle of July 1931, the Reichsbank lost approximately two billion RM in gold and foreign exchange.[78] This was not only due to the powerful disturbance to credit conditions throughout the world, but also to the rise in money circulation

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75. Economist, London.
76. Statistisches Jahrbuch.
77. W.C. Langsam, Documents and Readings in the History of Europe since 1918", (N.Y. 1939).
78. Cf. chart No. 1; also Kenyon W. Poole, German Financial Policies 1932-39, (Cambridge, Mass.); pp. 22.

originating out of increasing lack of confidence at home. Money in circulation rose (from the lowest point since early 1928) from 5,856 million Marks in May, 1931, to a high of 6,638 million Marks in December, 1931, thereafter declining strongly throughout 1932.[79] President Hoover's proposal on June 21st for a year's moratorium on Germany's political debt could only be accepted after the delay by the French government. The entire world focussed its attention on the alarming condition of Germany. The withdrawals continued and the Reichsbank saw its reserves dwindle to depletion. The total credits mopped up abroad amounted to 630 million RM.[80] Most of these funds, (420 million RM) came from the Central Banks of England, France, the United States and the Bank for International Settlements to tide over the date-line for payments due on June 30th. The flight could not be stayed away by such marshmellow measures. The Reich found itself forced to withdraw its support of the very important Darmstädter and Danat Bank, which was compelled to close its doors on July 12th, 1931. This was the last straw. There was a general run on all the commercial and savings banks which led to the decision of the government to close all banks and other credit institutions on July 14th, 1931. On July 15th, 1931, all foreign exchange dealings were

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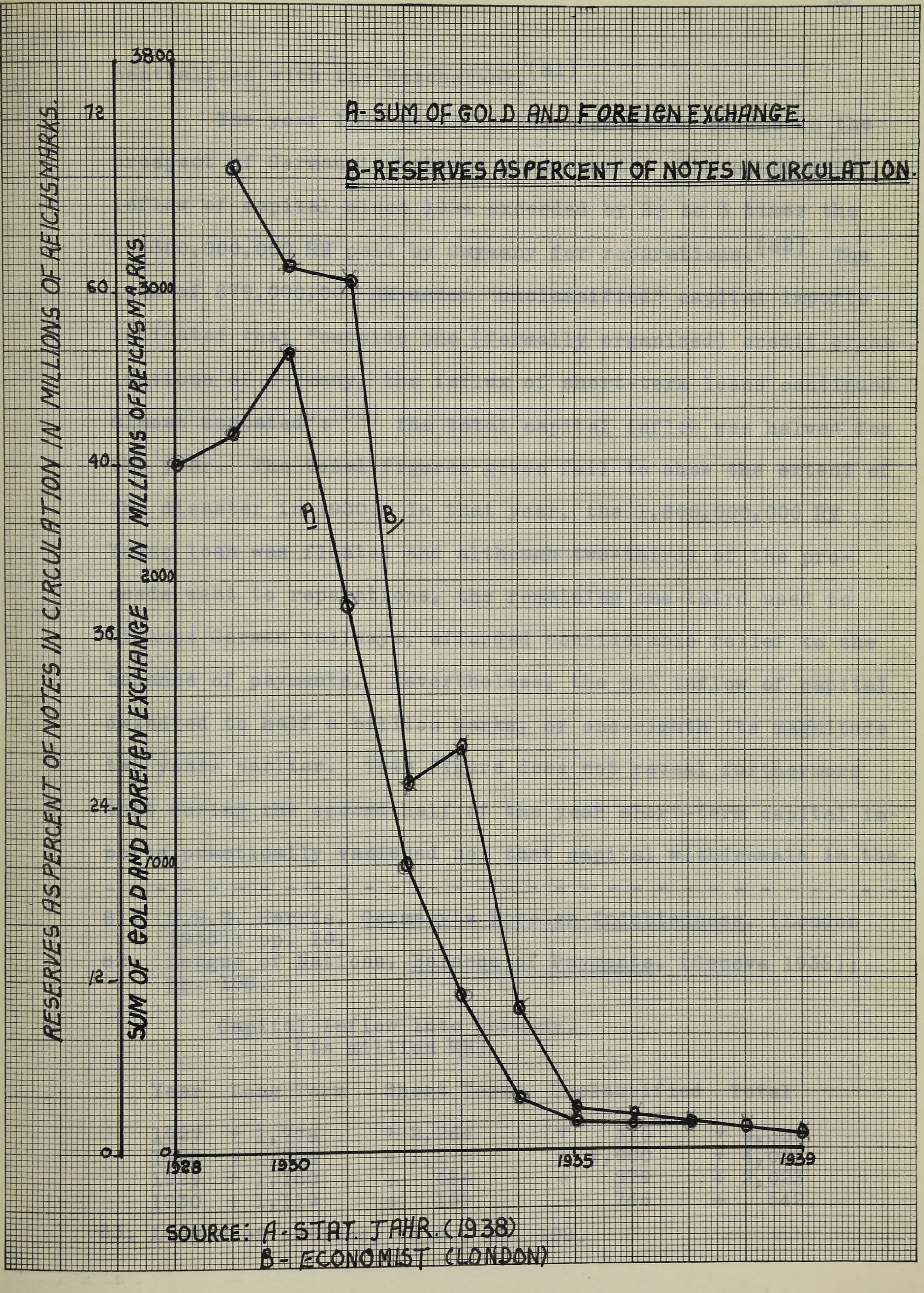
79. Statistisches Jahrbuch.
80. Guillebaud, <u>The Economic Reserves of Germany from 1933 to 1938,</u> (London 1939); pp. 21.

No I.


A- SUM OF GOLD AND FOREIGN EXCHANGE.
B-RESERVES AS PERCENT OF NOTES IN CIRCULATION.
RESERVES AS PERCENT OF NOTES IN CIRCULATION IN MILLIONS OF REICHSMARKS.
SUM OF GOLD AND FOREIGN EXCHANGE IN MILLIONS OF REICHSMARKS.
72
60
40
36
24
12
0
3800
3000
2000
1000
0
A
B
1928
1930
1935
1939
SOURCE: A-STAT. JAHR. (1938)
B- ECONOMIST (LONDON)

centralized with the Reichsbank.[81]

The year 1930 marked a thorough-going change in the prospect of Germany's balance of payments. The continuous inflow of capital since 1924 exceeded by 2½ to 3 times the 10,300,000,000 RM paid by Germany for reparations.[82] The item of 879,000,000 RM under "unclassified" capital imports indicated that "outside the (formally organized) credit organizations of Germany, the influx of short-term loans continued almost unabated";[83] the total capital inflow was halved for the year. The total figures given fail to show the extent of the disaster in 1930. In that year, the 1,800,000,000 RM Young loan was floated and although two-thirds of the proceeds went to reparations, the remaining one-third used to finance German railways, afforded considerable relief to the balance of payments. Nevertheless, the net inflow of capital dwindled to half a billion Marks, or one-eighth its magnitude two yeats earlier. This figure does not reveal furthermore that during the second half of the year short-term capital imports practically vanished nor that capital withdrawals in the

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81. C.R.S. Harris, Germany's Foreign Indebtedness, (London 1935); pp. 10.
82. League of Nations, Balance of Payments, (Geneva 1938); pp. 108.

Capital Inflow into Germany.
(in million RM)

Year	Long Term	Short Term	Unclassified	Total
1927	+ 1,778	+ 2,264	+ 310	+ 4,352
1928	+ 1,778	+ 1,270	+ 1,000	+ 4,058
1929	+ 1,160	+ 484	+ 879	+ 2,023
1930	+ 1,119	+ 169	- 746	+ 542.

83. League of Nations, ibid., pp. 108.

aggregate amounted to over a billion and a half Marks.

Under these circumstances the balance of trade took a spectacular turn from passive to active.(84) This change was greatly intensified by the alteration of the terms of trade in Germany's favour following the collapse of markets for inelastic raw material imports relative to her industrial exports. This could not turn the tide.

The loss of gold and devisen from Reichsbank reserves continued and only in February 1931 did the drain show signs of temporary retarding.(85) On March 30th, 1931, a more onerous deflationary "saving budget" came into force by emergency decree, but despite a contemplated saving of 1,550,000,000 RM under the 1932 budget a new deficit had accumulated by May. The news of this debacle impinging upon the panic situation created by the Credit Anstalt resulted in a veritable impasse. June, 1931, witnessed a war of nerves. Both the left and right predicted the collapse of "decadent capitalism" in Germany and the breakdown of the Versailles system. Schacht, who was at this time in retirement from the Reichsbank proclaimed that Germany's ability to pay had come to an end and that dictatorship was inevitable. The failure of the Austrian Credit Anstalt enabled the French to intervene and wreck the Anschluss. Still, Paris refused to help the German-stricken economy. New York had not recovered from the stock exchange

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84. See graph II. (1928 minus 1,229.4; 1929 plus 35.9; 1930 plus 1,642.3)
85. Cf. chart. I.

crisis. The commercial Bank in order to replenish their deplete reserves sapped away by the capital flight, turned heavily to the Reichsbank. Traditional bank rate technique (rise from 5 to 7 per cent) failed to stem the tide ! By the time of the Hoover Moratorium (June 16th) the Reichsbank had lost a billion Reichsmark in reserves and was approaching the limit of the 40 per cent against its notes. The man in the street watched the approach to this sacred line with superstitious misgivings expecting collapse as soon as the limit was exceeded. The legal suspension of reparation payments for the period July 1931 to July 1932, and even to make onlynominal tender without actual payment of the "unconditional" annuity of 600,000,000 RM(86) had a psychological explosive effect instead of an encouraging one.

The loans from abroad were rapidly dissipated by the capital flight. "Nor was the situation materially helped by a joint guarantee to the Golddiskontbank of 500,000,000 RM by a thousand of the largest firms."(87) In July the Darmstädter- und National-Bank failed. The "orthodox" technique of converting credit into cash was inapplicable to a crisis in which withdrawals resulted only in equivalent sapping away of devisen to foreign countries. The banks were closed. The

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86. Economist, "Reparations and War Debts Suppelment", January 23rd, 1932; pp. 7.
87. Ellis, <u>Exchange Control in Central Europe,</u> (Cambridge 1940); pp. 166.

Reich undertook to guarantee depositors' claims. The Stock Exchange was shut and July 15th witnessed the introduction of exchange control in Germany.

The fate of Austria was of course closer linked to the Credit Anstalt debacle. The Treaty of Versailles transformed Vienna from a commercial centre into an exchange without speculators. Tardy relief from abroad failed to check the ever growing queues. The Bagehot principle for meeting runs was applied and the central bank increased its private discounts from 69,500,000 to 451,300,000 schillings during May 7th to May 31st, "almost exactly paralleling the Credit Anstalt withdrawals".[88] Although the note circulation increased from 905,400,000 to 1,400,600,000 schillings, this was not inflationary since it merely supplanted deposits. Gold and devisen dropped from 855,500,000 to 732,200,000 schillings during May alone.[89] The discounts rate was raised from 5 to 10 per cent during the June-July impasse.[90] Still the Bank of England and Bank for International Settlements refused to help unless the Austrian government would underwrite the obligations of the threatened bank. In compliance with this demand, the underwriting law was enacted three days later,

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88. Ellis, op.cit., pp. 27 cf. Also "First Quarterly Report on the Financial Position of Austria", (Geneva), Appendix XII, pp. 25; "Second Quarterly Report", (Geneva), Appendix VII, pp. 25.
89. Statistisches Jahrbuch.
90. Economist, London.

and the Austrian government guaranteed National Bank rediscounts of 120,000,000 schillings to the Credit Anstalt and Austrian Savings Bank advances of 50,000,000 schillings. France refused to co-operate unless the Anschluss with Germany was renounced and the reorganized bank supervised by the Quai d'Orsay. Withdrawals from Vienna continued. On June 16th, the French conditions for a possible loan took the form of an ultimatum which caused the collapse of the Ender cabinet in Austria. At midnight came the announcements of a 150,000,000 schillings credit from the Bank of England.(91) The Bank for International Settlements followed with another 90,000,000 schillings. June 23rd, 1931, witnessed the Hoover Moratorium. Optimism followed. But this breathing spell was short-lived for on July 13th, the failure of the Darmstädter- und National-Bank led to the German bank holidays. A secondary crisis set in.

Devisen reserves in the National Bank shrunk from 855,000,000 to 566,000,000 schillings between the May crisis and the beginning of August despite the 240,000,000 schillings credits from the Bank of England and the Bank for International Settlements. The Bruins Standstill Agreement upon the remaining 240,000,000 schillings of Austrian short-term debts

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91. There was no collaboration between England and France at this time. In truth, their policies were largely antagonistic to one another.

was signed at Basle in August 19th, 1931. During August a further 5,000,000 schillings was withdrawn from Vienna Banks.

Mr. Rost van Tonningen, the League Representative in Austria, writes: "The number of receiverships has increased considerably during the last few months and reached in November 1931 the average weekly figure of 89.8 against 59.3 in November 1930. Bankruptcies attained their maximum for the year at 19.3 in November, a figure higher than in any month of 1930.(92) It is therefore not surprising that the Stock Exchange was closed on September 21st, to stay the process of liquidation and capital flight through the purchase of foreign securities.(93) Confidence in the currency waned.(94) And premia for gold currencies on all important transactions became a commonplace. Although the Bank found it more seemly to sell only at the National Bank official rate, the informal, but legal, coffee-house dealings involved premia of 10 to 15 per cent. Neither is this surprising. "In Austria, there was a difference between gold and schilling prices in December (1931) of 25.9 per cent.(95) The Bank was therefore forced to officially limit its sales of devisen to "legitimate" import demands; but even so the depleted supply proved highly inadequate. More draconian measures were inevitable and on October 7th the Minister of Finance suspended remittances abroad by

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92. "First Quarterly Report on the Financial Position of Austria", (Geneva); pp. 12.
93. The Exchange was re-opened in November, 1933.
94. "Second Quarterly Report on the Financial Position of Austria", (Geneva); pp. 14.
95. Ibid., pp. 15.

money order.[96] Two days later witnessed "the introduction of foreign exchange regulations by decrees of October 9th, 1931, supplemented by decrees of October 16th, November 18th and a decree of December 23rd, 1931, which was approved by Parliament on January 9th, 1932."[97]

Hungary's struggle with agricultural depression and international indebtedness is typical of the Danubian, Balkan and South American difficulties. They, too, indulged in excessive capital imports between 1924-30.[98] Her banking system was inept and lacked the technique for successful control. The general trend of Neo-Mercantilism hampered her agricultural exports and the adverse turn in her terms of trade slowly but surely pressed her into the mire of depression. Over 500,000,000 pengo were short-term obligations invested in federal, communal and agricultural projects without much reference to immediate yield.[99] The results were within the bounds of prophecy. Hungary had become oriented to a continuous capital influx; the prosperity fever was contagious and both the American lender and the European borrower sacrificed prudence for exorbitant imaginary profits. In 1929 capital import sufficed only for the debt service,

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96. Between 1924-1930 Hungary borrowed 2,026,000,000 pengo, one-fourth of which was on short-term. Ellis, op.cit., pp. 72.
97. "First Quarterly Report on the Financial Position of Austria", (Geneva); pp. 10.
98. Cf. footnote 96.
99. Cf. First, Second & Third Quarterly Report on Hungary Section H - State Budget.

and during 1930 capital was withdrawn from Hungary on balance, reducing the reserves of the National Bank by one-third. Total indebtedness in 1931 amounted to 4,310,000,000 pengo, with not more than 2,470,000,000 pengo at long term.[100] The per capita foreign and domestic indebtedness of 613 pengo in 1931 was the largest in Europe, half again as large as Germany's or Austria's. The foreign and domestic withdrawals left the Hungarian banks by June 1931, highly illiquid.[101] The banking practices of Hungary as well as Germany were not in the least conservative. There was an intimate association of banks with industry in Hungary, and the merging of all types of banking business in the same institution, including commercial and mortgage operations, rendered the whole credit structure particularly vulnerable.

"The consequence of European agricultural autarchy, conjoined with competition of American grains produced under revolutionary cost reductions was a catastrophic reversal for Hungary."[102] France and Germany raised their wheat yield per hectare from 13.9 to 17.1 quintals and from 16.6 to 24.2 quintals respectively.[103] German wheat imports in the same period declined from 14,448,000 to a mere 3,000 quintals over the nine years 1924-1933.[104]

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100. Quarterly Report, Section III, Appendices.
101. Cf. League of Nations, "Commercial Banks", (Geneva 1934); pp. 133 et seq.
102. Ellis, op.cit., pp. 75. Also Second Quarterly Report, pp. 11 and 12.
103. P.N. Panaitesco, <u>Les contingentements dans les relations commerciales avec les pays agricoles,</u> (Paris 1935); pp. 9.
104. Ibid., pp. 25.

This Neo-Mercantilist drive, commingled with the precipitous fall in agricultural prices, depressed Hungary's exports. Agricultural exports, taken at their actual values declined to less than half in two years. The "agricultural price shears" reduced the ratio of agricultural prices to non-agricultural wholesale prices from 103.7 per cent in December 1929 to 82 per cent in December 1930 and 65.4 per cent in December 1931.(105) This simply meant that the means of payment for industrial imports were on a steady decline.

When the balance sheet of the Credit Anstalt appeared on May 8th, 1931, there was a general run on the Hungarian General Credit Bank. Withdrawals amounted to 45 per cent of the bank's liabilities. Rediscount rate was raised from 5,75 to 7.04 per cent.(106) Free exchange and payments were maintained despite a shrinkage of gold and devisen reserves from 47.9 to 39.4 per cent over the two months May and June.

On July 13th, the Danat Bank failed and Germany declared her "Bank Holiday". Hungary followed suit. The banks were closed till the 17th of July 1931 and the Stock Exchange till September 1932. July 17th witnessed the first decree monopolizing the foreign exchange market and forbidding outward payment without permission of the National Bank.(107)

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105. World agricultural production on a 1925-29 base stood at 104 in 1929, 103 in 1930 and 1931, and 102 in 1932; indices of industrial production stood at 114 in 1929, 101 in 1930, 86 in 1931 and 73 in 1932. World Economic Surveys.

106. League of Nations (1) Austria - Public Finances, Third Report April-August 1937, pp. 24.

107. First Quarterly Report, Section 5, Monetary and Financial, also Second Quarterly Report, pp. 11.

Fever heat panic followed. Note circulation increased from 159,000,000 pengo in July to 504,000,000 in August, 1931. A Central Bank support to institutions suffering withdrawals necessitated an expansion of its bill portfolio from 244,000,000 pengo on May 7th to 608,000,000 pengo on August 7th. Exchange control was supplemented by a Moratorium on foreign debt.

With the depreciation of sterling and the increased exports(108) following upon the withdrawal of credits and the flight of capital from the debtor countries, foreign exchange control was forced upon still more countries, for still more reasons. The relatively greater decline of agricultural prices menaced the domestic agricultural production of the countries importing the "simpler foodstuffs", and tended to endanger the stability of the currencies of these countries whose chief export articles were agricultural produce. In the case of producers and importers of agricultural products, a fall in agricultural prices necessitated increased protection if the existing incomes and activity of the agricultural section of the community were to be maintained. In the case of producers and exporters of such commodities either limitation of imports or af all out-payments had to be introduced if the menace to the currency was to be obviated. Exchange control was the technique applied to meet both these ends.

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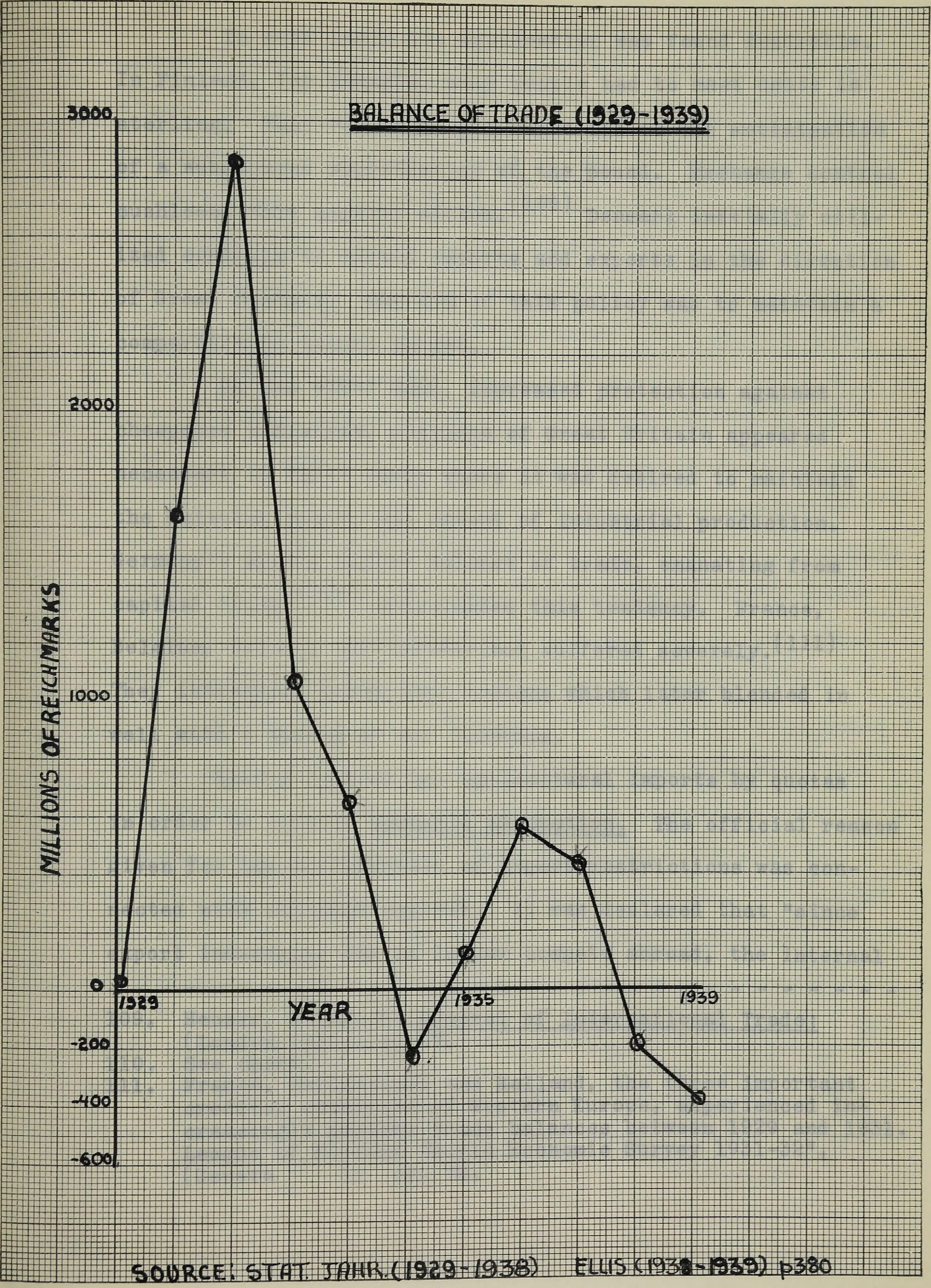
108. See Chart German Balance of Payments. No II.

No II.


BALANCE OF TRADE (1929-1939)
3000
2000
1000
0
-200
-400
-600
MILLIONS OF REICHMARKS
1929
YEAR
1935
1939
SOURCE: STAT. JAHR. (1929-1938) ELLIS (1938-1939) p380

In some cases its application was found desirable. In Finland, for example, many people had to meet debts in sterling. They rushed to pay these off in the anticipation of a subsequent appreciation of the pound. Exchange control cushioned this capital efflux.(109) Denmark initially utilized controls to direct imports and exports in the direction of Great Britain. The aim of this policy was to maintain a comparatively secure market.

On the other hand, increased protection against cheapened industrial products of Great Britain appeared necessary in those cases where it was desired to maintain the existing nature and extent of industrial production. Germany's sudden active balance of trade, emanating from capital flight(110) accentuated this tendency. France, Belgium, Holland and Switzerland suffered severely.(111) They introduced quota restrictions which later blended in well with a system of war controls.

Latvia limited her agricultural imports by quotas in order to protect domestic production. The official reason given for the introduction of import restrictions was connected with exchange control. It was declared that "since export industries can no longer compete abroad, the internal

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109. Heuser, Heinrich; Control of International Trade; (London 1939); pp. 7.
110. See chart.
111. France, Switzerland and Holland, the three important creditor countries of Western Europe, experienced increasingly passive trade balances between 1929 and 1931. League of Nations "World Economic Survey 1931-32", (Geneva); pp. 78.

market must be reserved for them".[112] Originally it was a "pure" quota introduced on the 15th of October, 1931; soon licenses and tariffs were added to it. The combined system was gradually transformed into one of exchange control rather than quantitative regulation of foreign trade. Devisen controls, introduced "to maintain domestic activity", largely grew out of conflicting interests prompted by opportunism and self-aggrandizement.

Each country was interested in its own immediate stability. Each control was pertinent to a specific circumstance. The Greek balance of trade was active throughout 1931. Still the Chamber of Commerce proclaimed that exchange restrictions "constituent dans les circonstances presentes la sauve garde la plus sure de la drachma, et peut-etre la seule maniere positive pour regler la situation ".[113]

Estonia too regulated imports through exchange control. In November, 1931, the Minister of Finance announced the necessity of keeping the <u>value of the Estonian crown stable.</u> Import restriction through exchange control, he stated, was one of the means to achieve this end.[114] With the exception of isolated cases, all these restrictions were introduced for currency reasons rather than the protection

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112. Industrie und Handel, November 6th, 1931; quoted by Heuser, op.cit., pp. 20.
113. Le Messager d(Athenes No. 3026. February 27th, 1932; quoted by Heuser, op.cit., pp. 34.
114. Industrie und Handel, November 14th, 1931; quoted by Heuser, op.cit., pp. 38.

of domestic economic activity. Nevertheless, the authorities in Estonia foresaw that <u>any</u> kind of import restriction, regardless of its motives, must have incidental protectionary effects and <u>took exceptional care that internal industry might not expand too much beyond the shelter of</u> import limitations.(115)

The case with Rumania is not novel. Prices of exports were falling relatively faster than those of her import products, and a speedy adjustment of the balance of trade to the changed conditions of international demand was thus made more difficult. Moreover, on account of exchange control in other countries, anticipated foreign exchange receipts did not materialize. The initial reason for restrictions on current and capital account, therefore, lay in the tendency of the balance of trade to become <u>less</u> active.(116)

In May, 1934, Italy believed herself forced to introduce exchange control as a result of capital efflux and an adverse tendency of the balance of trade.

Poland adopted quotas in 1933 because they were in fashion. By 1934 and 1935 the fashion became a style and the disastrous deflationary policy followed in those two years ushered in a full fledged system of exchange control.(117)

Greece, Estonia and Rumania limited their imports in 1931 to improve their balance of payments. Such <u>quantitative</u>

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115. This is a very important example for Canada.
116. Bulgaria suffered from the same difficulty.
117. March 1936.

restrictions in conjunction with currency measures were employed originally to maintain the currency at par. Austria, Czechoslovakia, Hungary, Bulgaria, Latvia, Lithuania[118] and Poland[119] sought the same objective through currency measures. Denmark and Finland were the first countries to introduce exchange control simultaneously with devaluation. Greece maintained a combined quota and exchange control system after allowing her currency to depreciate by about 50 per cent in 1932. Austria adopted the same policy a year later and Czechoslovakia and Estonia followed. In all these countries the original qualitative restrictions ultimately gave way to complete or nearly complete systems of exchange control. The reason for this probably lay in the existence of other restrictions introduced to prevent capital flight and the expatriation of national funds.[120]

Russia,[121] Iran and Portugal had exchange control systems even prior to the crisis of 1931.[122] Germany adopted it in that year. Shortly afterwards, Angola, Argentina, Austria, Bolivia, Brazil, Bulgaria, Chile, Czechoslovakia, Denmark, Estonia, Finland, Greece, Hungary, Iceland, Italy,

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118. Lithuania introduced exchange control in October 1935.
119. Poland adopted controls as late as April 1936.
120. This was particularly true in the case of Austria.
121. Cf. Arnold, Banks, Credit and Money in Soviet Russia, (N.Y.); pp. 313.
122. The mention of exchange control can be found as far back as Mun's "England's Treasure by Foreign Trade"*. The technique was also practised during the World War by most belligerent countries and retained as a rehabilitory measure thereafter. Germany, for example, liberated her exchanges only as late as 1927. *[London, 1601].

Jugoslavia, Latvia, Lithuania, Nicaragua, Poland, Turkey and Uruguay followed. Japan emulated the example which Europe had set, and in July 1932 carried devisen controls into Asia.(123)

Wherever applied, exchange control was a miscellany of very different official measures, exhibiting wide variations in form, purpose and causation, from place to place, and from time to time.

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123. See Frontpiece.

Theoretical Aspect

of Foreign Exchange Control

CHAPTER III

Exchange control is an integral part of the economy to which it belongs. Different problems require different solutions and the technique established will be dependent upon the aims in view and the means in hand.

The creditor countries depressed the foreign exchange value of their currencies below purchasing power parity in the hope of obtaining a differential advantage in foreign trade and/or raising the domestic level of commodity prices. England was primarily interested in securing the differential advantage. She established the Exchange Equalization Account not merely to minimize the day-to-day fluctuations in the foreign exchange value of the currency[1] but also to preclude it from rising relative to the American dollar. Hall is of the opinion that "since April 1933 the whole policy of the Exchange Account seems to have been changed. The pound becomes a satellite of the dollar as a result of the deliberate choice of the Exchange Account, and the gold currencies are allowed to appreciate in terms of sterling to the level necessary to equate the dollar and the pound."[2]

America's balance of trade position was probably the strongest in the world. True, after the president's "Bank Holiday" of March 6th to 9th, 1933, the Federal Reserve Board

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1. Cf. F. Cyril James, "Canadian Chartered Accountant", April and May 1940. Dr. James does not mention this point.
2. N.F. Hall, Exchange Equalization Account. (London)

suffered a considerable drain on its reserves; the ratio of reserves to deposits fell from 65.6 per cent in February to 45.1 per cent in March.(3) There was, however, no serious danger as far as external pressure was concerned : the president probably had plans for internal recovery which would be facilitated by departure from gold. In June, the United States went off the "streamlined" gold standard. The crisis was largely a Keynesian one, and the president wished to outwit the "profound and conniving policies which must lie in the minds of the British."

There were many countries caught in the crisis of 1931 that were compelled to accept more draconian measures. They could not risk exchange depreciation and were not able to appropriate billions of dollars for the purpose of creating stabilizing funds. For these a more <u>effective</u> and <u>cheaper</u> method of exchange control seemed essential.

In one form or another, state intervention for the purpose of influencing the exchange rate has been practised since inter-regional and international trade began. Currency and discount policy, the management of the gold standard, open market operations, exchange equalizing funds and depreciation are all factors which influence the exchanges. The Economies of New Mercantilism — import quotas and levies, export subsidies and bounties — may or may not be guided by

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3. Federal Reserve Bulletins.

a desire to influence the exchanges but their impact upon them is incontrovertible. All foreign trade policies can be similarly included, since they affect the supply of and the demand for particular currencies. In other words, a comprehensive concept of exchange control consists of any measures or policies taken by a central bank, government or other institution to influence the rates of exchange, regardless of the motives and causes pursued. This definition is too broad to allow for adequate distinction between the various techniques involved which differ from each other as greatly as the difference between control and no control.

One factor, nevertheless, is common to them. All the exchange manipulations mentioned depended upon the free and normal operations of the foreign exchange market. The authorities permitted the freedom of action but intervened to offset "undesirable" tendencies. Exchange control proper, on the other hand, precludes the freedom of action and prohibits directly any practices which the authorities deem contra public interest. The state adopts active measures to equilibrate the demand for and the supply of devisen at the official exchange rate. In this sense, control is a recent innovation in World Finance, born in the days of the Russian Revolution, practised during the World War, continued as a rehabilitory measure and winning pre-eminence following the 1931 crisis.

This thesis is primarily interested in the direct government application of exchange control and not in the diverse indirect techniques which influence the foreign value of the exchanges.

This category can also be subdivided relative to the severity of measures applied. Beginning with the operations of the Russian Central Bank in 1922 and Germany's "moral suasion" in 1924 to use devisen held abroad,[3A] we come to the lax system launched in England at the outbreak of hostilities where pre-war obligations in gold and devisen were to be permitted. Gradually all outward capital remittances are forbidden and the complementary measures necessary to enforce such legislation are inaugurated. The next step usually is official foreign exchange quotations with no other quotations permissible. If the demand for and supply of devisen cannot be equilibrated at the official rate on account of capital flight or government interest and amortization payments exceeding the country's exports in terms of imports "the mechanically appropriate action would be a stoppage of the excessive capital movement."[4] This we can label 'paper differentials'. On the other hand if the demand for foreign

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3A. Dr. Moritz J. Bonn, in discussion, claimed that this policy was stringent enough to be placed on the border of this category.
4. Ellis, op.cit., pp. 5.

exchange exceeds the supply at the official rate on account of discrepancies in real values (such as a relative inflation or changes in real costs and/or demand, producing adverse barter terms of trade) restriction of credit, reduction of costs, or an increase in production is necessary.(5) Theoretically speaking, Ellis is probably correct in arguing that authoritarian rationing of devisen only becomes necessary during the last stage when relative price-differentials exist. Here the demand for devisen is bound to exceed the supply at official exchange rates since imports carry profitable windfalls and exports are penalized. For practical purposes (as far as allocation of devisen is concerned) it is very doubtful whether this last classification is very instructive. Primarily, Cassel's "inexorable" laws never were a function of price indices. The majority of transactions are not hedged. Importers must therefore discount the future trend of the currency in question. During a crisis these "Other factors" which influence the exchange value of the currency, primarily political uneasiness manifesting itself in capital flight, play a more predominant part in the determination of exchange rates and become the potent reason for devisen rationing. The great proportion of wealth which is liquid today exaggerates this tendency. What we can say is that once capital movements have been harnassed, a downward adjustment of the exchange rate (with qualifications) becomes a function of the export-import price indices (or a more reliable) index of equilibrium. It must also be noted

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5. Ellis, op.cit., pp. 5.

that capital flight may very well take the form of foreign deposits through exports at fictitiously low rates, depositing the difference between the low rate and the real rate abroad. Once an official exchange rate is established, rationing of devisen becomes indispensable. Lastly, viewed from the angle of liberal international trade, exchange control reaches its nadir in being perverted to a weapon of commercial autarchic policy.(6)

The functions of foreign exchange control can be closely collated with the relative stringency of the above mentioned measures.(7) Primarily, it can be used to prevent the unregulated export of capital and encourage its import.(8) The conservation of gold supply and providing devisen for foreign debt service falls into this category. An extensive amount of foreign and/or domestic capital flight leads to currency depreciation. The prevention of the latter may be conjoined with the prevention of the former. Secondly the control of exchanges may be necessary to insulate an economy moving from one neighbourhood of equilibrium to another.(9) Although Prof. Ellis mentions an increase in gain from international trade and securing cheap foreign exchange for government purposes(10) as functions of exchange control these can hardly be called intended purposes. It seems more accurate to call them by-products which in certain cases be-

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6. Paul Einzig, Bloodless Invasion, (London 1938).
7. Cf. Ellis, op.cit., pp. 290 et seq.
8. This has always been the primary purpose for its application.
9. Prof. Haberler justifies exchange control, under pertinent circumstances, on this ground. Ellis, op.cit., pp. 293.
10. This was actually the case with Poland.

come more important than the product itself. Retaliations against foreign controls (quotas, tariffs and the like) have been another usage of exchange control. Continuing in accordance with severity, exchange control has been employed, deliberately or not, to protect domestic production. Last of all, exchange control performs an important function as a sinew of war, or as in pre-bellum a technique of economic and political autarchy. The assurance of essential imports, the preclusion of devisen expenditures on luxuries and travel, the safeguarding of accumulated savings in the form of foreign securities and the general regulatory instrument of planned economy all fall into this category of exchange control.

In its most common form, exchange control includes four predominant elements: (1) the prohibition of capital export unless under supervision; (2) the maintenance of more or less artificial high rates of exchange; (3) the rationing of devisen, and (4) the balancing of trade between specific countries. These characteristics have taken a great diversity of forms, and the actual combinations of these forms are legion. Some countries retain a unique overvalued rate; others adhere to overvalued rates, or even resort to discriminating multiple rates. Bilateralism which already embraces part of the world, has greatly increased during the present war. Neither are the methods used in applying these techniques ubiquitous; bilateralism is sometimes secured directly through barter,[11] clearings[12

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11. Germany with Russia.
12. Germany with the Balkans and the Danubian states, etc.

and/or payment agreements.[13] Indirectly, exchange control often consumates into a trade policy striving for a balance between imports and exports.[14]

The endless ramifications of exchange control, including libraries of legal provisions which are indispensable to the success of these measures, cannot be examined in this thesis. The success[15] or failure[16] of application, nevertheless, spells control or ruin.[17] Although foreign exchange control was not based on any theoretical predilections, it is important to examine whether fundamental principles of international trade have been undermined by its application. The technique warrants certain theoretical considerations which will be corroborated, or not, by the history of the movement. "For it is by no means the case that under exchange control the market mechanism ceases to function altogether or that the laws governing it can be ignored."[18]

The intricacies of foreign exchange control begin, and do not terminate, once a rate of exchange has been chosen. In the case of "free" currencies, the exchange rate is largely determined by the relative production and money indices of different countries. Do these same factors operate when ex-

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13. The agreements between Germany and Britain are one of the numerous examples.
14. The Canadian-American case is an example of this tendency.
15. Germany.
16. Austria.
17. The hardships which evasion wrought on the agricultural population of Austria while industry pocketed lucrative windfalls is a glaring example of ineffective exchange control.
18. Gottfried Haberler, Theory of International Trade, (London, 1936) p-83 et seq

change controls exist ? This is one of the questions which the experiences of Hungary, Austria and Germany will answer.

Under the "pure" gold standard, movements of the yellow metal and hence proportional changes in the volume of money[19] responded to changes in the balance of payments. Exchange fluctuations were therefore restricted to the gold export and import points. This implied an adjustment of the <u>internal</u> economy through income and price changes to changes in the balance of payments. On the other hand, under a "pure" paper standard, variations in exchange rates would "adjust" the various national economies to one another. Neither of these two extremes are today applicable. While frequent movements of exchange rates are desired by none, the absence of internal monetary control would be rejected by all. The problem, in truth, is to reconcile so far as possible autonomy of domestic credit policy with reasonable stability of the exchanges. Exchange control, it was believed, could guarantee <u>both</u> stable exchange rates and insulate an economy from external factors. That is, <u>international price</u> and <u>exchange equilibrium were ruled out to start with</u>, since adjustment was precluded by the fixed official exchange rate and the control price structure on the other. As long as the country retained trading relations with the rest of the world, however, changes in the items on the current and capital account brought

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19. That which is customarily accepted in the discharge of debts and purchases in a political and geographic society.

about by price and income fluctuations or by more evanescent tendencies, were bound to manifest themselves in changes in the real value of the exchange rate. If the rate chosen by the authorities is in harmony with the "equilibrium" rate, no difficulty is encountered as long as no fundamental changes occur in the price and income structures of the respective countries. But the mere retention of controls usually signifies that underlying maladjustments already exist. The currency in the vast majority of circumstances is overvalued. Exports are therefore penalized and imports artificially stimulated. Reserves dwindle. If the supply of and the demand for devisen at the official rate are to be equilibrated, <u>direct</u> manipulation of the items on the balance of payments becomes essential. <u>Under controlled exchanges the official rate must either become an active determinate (as well as being a determinant), and alter export—import relations between trading partners or the nominal rate must be circumvented through various depreciation techniques.</u> That is, the real rate of exchange is either reduced or a new neighbourhood of equilibrium is established through current and capital account manipulations. If camouflaged devaluations do not set in and alterations in the balance of trade are impossible, the commodity balance will even turn more adverse and the further shrinkage of reserves and devisen will ensue. This was exactly what foreign exchange control was to prevent. Even if a lower rate is accepted, exchange control per se leads to the insulation of many commodities from international markets, raises factor costs and leads to higher export prices. For a number of reasons this tendency is liable to continue through the period of exchange control. 1) The mere psychological fact that the authorities refuse to permit export of capital provides an impetus in that direction. 2) Behind the shelter of exchange control the government may carry through an expansionist policy with the result of an unfavourable development in the balance of trade. 3) Increased prices of restricted products may raise internal costs either directly or through an increase in substitution costs. Foreign exchange control therefore eats into itself and forces recurrent legal or camouflaged devaluations. This phenomenon resembles Mr. Keynes' proposal for a lowering of the rate of interest to solve the problem of "involuntary employment".[20] Once more it seems quite clear that the myths of monetary and autarchic miracles are built on quicksands. Nevertheless it is fallacious to imply that the official rate of exchange lacks significance. In truth, its preservation represents one of the primary aims of exchange control and necessitates the whole apparatus of bilateralism. When dealing with the term "overvaluation" and its effects upon trade, we shall refer to imports and exports actually made at the real rates (i.e. payments made

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20. Viner, Quarterly Journal. Nov. 1936

with "Aski" Marks, blocked accounts and other export stimuli) and not the mere nominal rate. By the "equilibrium" rate in "free" countries Pigou understands that rate for which "a unit in the country of export shall buy a claim in the country of import to a unit minus the cost ... involved in sending it there."(21) Or more simply, eliminating discriminating monopoly, that rate of exchange which does not permit import or export windfalls in commodities. The "fictitious" equilibrium(22) under exchange control on the other hand, is that rate which endeavours to equilibrate exports and imports or forces(23) them to stand in some other fixed relation predetermined by authority.

Apologists for exchange control seem rather inconsistent in proclaiming that the institution is a system of "modern money" which "corresponds completely to the main features of the so-called 'free' international payments", and in the same breath proclaim that "the freedom to purchase on the cheapest market ... has been changed to a compulsion to purchase on certain markets."(24) That the system of ex-

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21. A.C. Pigou, Essays in Applied Economics, (London 1923); pp. 157.
22. Even if capital flight is checked the exchange controlled rate is "fictitious" for, in a practical sense, ~~an~~ the "equilibrium" rate is in the all-inclusive Keynesian terminology. This follows since history which has not happened cannot be interpreted and it is impossible to ascertain what the "free" rate would have been, had controls not existed.
23. Paul Einzig, The Bloodless Invasion, (London 1939);
24. Dr. Carl Hermann Müller, Outline of Exchange Control, (Berlin 1939); pp. 335; quoted by Ellis, Exchange Control in Central Europe, (Cambridge 1941); pp. 344.

change control is "capable of combining political direction of economie with easier technical management"[25] may be very true in the light or darkness of totalitarian economy, but it has nothing in common with liberal international trade. The latter is precisely built upon the relative freedom of choice and competition between entrepreneurs for domestic as well as international commodities. One thing is certain: exchange control permits the discrimination in price between internal and external markets. The subsidies necessary for these "additional" exports are either levied on importers or on the community at large.[26]

The German representative to Geneva said more than he knew in stating that "the 'only' difference really is that in Germany discrimination is official and in other countries it is private."[27] This removes the pith and substance of the free marginal utilization of international resources. We can all agree with the German apologist that "it is impossible to make any sort of international cost calculation if the prices are established by the exchange control offices of the two or more states. In these prices fixed by these offices it is impossible to separate the two essential elements of this calculation: 1) the price, and 2) the rate of exchange."[28] But does not this signify the very obverse of "free" international payments ? If we accept the principles of comparative

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25. Dr. C.H. Müller, op.cit., pp. 13; quoted by Ellis, op.cit., pp. 344.
26. Germany applied both techniques. Sales taxes on consumers' goods to stimulate exports were levied in 1935.
27. Geneva Research Centre, Provisional Record of the Conference on Exchange Control, May 12-13, 1939; Ellis, op.cit., pp. 345.
28. Ibid., pp. 4.

cost as the criterion of "economic" trade movements, we have theoretical reason to believe that in the long run aggregate international trade must suffer on account of exchange control. There is no a priori ground, however, for the belief that trade should decrease for a specific country.[29] That is, intra-bloc trade may increase to a greater extent than the loss in inter-bloc trade. One man's meat may be another man's poison. Nevertheless, we would expect exchange control, (being an impediment to free capital and commodity movements) to reduce the maximum possible utilization of international resources.

Between different states the upward or downward trend of trade under bilateral agreements can go no higher than the exports of the "active" balance country and no lower than the exports of the "passive" balance country. There is therefore the theoretical possibility of trade increasing under bilateralism. Between the upper and lower limits, trade still responds to a profit and loss calculus. But the very existence of bilateralism relegates to discard the previously existing system of comparative costs (established by more or less free competition) and substitutes a regime of costs which have resulted from the arbitrary actions of authority. Still, the relative gain or loss from bilateralism can only be examined pragmatically.

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29. The principle of comparative cost looks askance at discriminating monopoly, but this is the chief economic phenomenon which admits the theoretical possibility of greater total gain with exchange control than without it.

The theoretical possibilities of foreign exchange control must be considered relative to a planned economy on the one hand, and one in which private enterprise is the predominating form of economic activity on the other. The technique may enable governments not only to control the economic activity of those under their immediate jurisdiction, but may also give them the power to make their policies more effective by exerting a profound influence on the activities of other states. For example, if a government has the power to exclude a foreign product from the domestic market and effectively controls internal production, the influence of foreign commercial policy of one state on the economic life of another is much greater than under conditions where the most that may happen is the raising or lowering of the tariff. The success of "planned" international trade depends on the extent to which a country is in a relatively monopolistic or monopsonistic position.(i) And the success of such discrimination requires the most competent technical and administrative experience. (Its inauguration inevitably leads to greater government control).

Given the possibilities of controlling foreign trade according to some preconceived plan, we shall examine 1) the probable effects upon the mass of consumers; and 2) the suitability of exchange control as an instrument of trade control under a predominantly "liberal" system of economic organization.

(i) This is an important factor which Canada must consider before equilibrating the American-Canadian dollar at par

Heuser states "the final result is generally a rise in the cost of living without a correpponding increase in the wage level."(30) "These results", he continues, "(on the whole reached empirically) are, of course the natural consequence of the extreme reduction in international specialization which trade regulation has brought about."(31) As we shall see in the chapter on "German Foreign Exchange Control", this conclusion is unwarranted for the economy as a whole.

Heuser seems to mimify the fact that exchange control was forced upon most countries and was never the result of volition. In most cases it meant limited trade under exchange control or no trade at all. It is therefore hardly instructive to compare trade under exchange control and what "would have been" under international specialization. Further international trade statistics may not be pertinent at all if we can show that exchange control was more a weapon of internal than external economy.

We have seen that the foreign value of a currency may be overvalued for two general reasons, 1) The crisis may be due simply to the flight of domestic and foreign capital.(32) 2) The weakness of the exchange may be due to the much more serious fact that the balance of payments on income account is chronically passive at the given exchange

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30. Heuser, op.cit., pp. 251.
31. Ibid., pp. 251.
32. Einzig has said that exchange control which prevents such hazards "assist in the working of normal tendencies instead of obstructing them." Einzig, Exchange Control, (London 1935);pp. 108.

That is, prices and income are above the equilibrium point relatively to other countries, (either because of inflation or because of the refusal to keep step with falling prices abroad).

These two cases seldom occur separately and each has a tendency to produce the other. Flight of capital can easily lead to credit inflation[33] and a long continued outflow of gold, resulting from the refusal or impossibility to adjust prices downward, ends by increasing bakruptcies,[34] destroying confidence and producing a flight of capital. But nevertheless the cases must be kept separate for purposes of analysis.

In the former case there is a flight of capital but the balance of payments on the income account remains in equilibrium. Prices are not therefore above the long-run equilibrium position, but they are too high, having regard to the temporary flight of capital. To effect the transfer either there must be a drastic contraction of the circulating media or, if the capital flight is replaced by credits granted by the central bank, the exchange must fall. Both these alternatives may be politically impossible and economically unwarranted. The chief object of exchange control is to avoid the dilemma by preventing capital flight. Whether it succeeded

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33. M. Rost van Tonningen, League of Nations, "First Quarterly Report on the Financial Position of Austria," Jan. 12th, 1932, pp. 10, Section 5.
34. League of Nations, "First Quarterly Report on the Financial Position of Hungary", Jan. 12th, 1932, pp. 11.

or not is one of the questions which this thesis purports to answer.

The League writes: "In all cases, the origin of the control was a deterioration of the balance of payments."(35) Further, "Countries which resorted to this measure had in all cases suffered a deterioration in their balance of trade and controlled exchange with the deliberate intention of checking imports and thus, they hoped, of protecting their foreign exchange reserves by reducing payments abroad on account of imports while allowing commodity exports to continue as freely as before."(36) Our analysis does not conform to this categorical generalization. The trend is correct, but there are exceptions even more important than the "rule".

Capital formation in "orthodox" theory, is largely a function of a high rate of interest resulting in increased savings and therefore increased investment. Savings, gold and devisen reserves in most countries under exchange control had reached a low ebb by 1931.(37) Moreover, the rates of interest thereafter were gradually lowered.(38) Exchange control also prevented a large capital influx since investors were not willing to lend money to defaulted countries. On the grounds of "orthodox" theory therefore exchange control should have had a deleterious effect upon capital formation and national

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35. League of Nations, "Report on Exchange Control," (1938); pp. 22.
36. Ibid., pp. 26.
37. See chart.
38. Economist, London. It is interesting to note that foreign exchange control interferes with the tendency of the marginal yield of capital to approximate uniformity.

income. If this has not been the case, we must accept the Keynesian line of causation. A low rate of interest relative to the marginal productivity of capital, coupled with government expenditures increases investment. An increase in investment results in higher incomes. Higher incomes produce greater savings. Greater savings result in greater investment. In a highly industrialized country, capital formation may under certain circumstances, very well be a function of a low instead of a high rate of interest.

Exchange control "renders export goods dear for two reasons: first, because prices in terms of domestic currency are relatively high and, secondly, because the domestic currency is overvalued."(39) We would therefore expect exports between clearing countries to bring higher gross prices and imports to entail higher costs than in the case of trade between "free" and exchange controlled currencies.

When the exports of a country imposing control are mainly <u>agricultural produce</u>, we would expect the agrarian population to fall into desperate straits. This follows since the tendency of exchange control is to reduce exports and twist the price structure in a manner unfavourable to the exporter. Industry, on the other hand, would gain 1) from the cheapness of domestic raw materials, 2) from the protection of the overvalued currency and 3) from the windfall accretions obtained trhough "necessary" imports at low official

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39. League of Nations, "Report on Exchange Control", (Geneva 1938); pp. 22.

rates on devisen.

In a country exporting industrial products we would expect a penalty on wages and profits. The incidence of the "tax" on exports will largely be a function of the relative monopoly position of the producer on the one hand and the degree of collective bargaining on the other. The large economic units are bound to fare better than the smaller ones. Imperfect competition will take full advantage of its position and the greater the divergence between official and "real" rates of exchange, the more potent become the

1) increased monopoly profits accruing to importers;

2) the windfalls gained through agricultural imports;

3) the loss to exporters;

4) the general protection to industry.

Almost as a corollary from these propositions it seems to follow that in most cases "Jim, the consumer, pays.(40)

The following chapters will corroborate, qualify or refute the theoretical premises made in this chapter in the light of empirical fact.

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40. The writer feels that Prof. Leacock's quotation may not be out of place:

"Each time that Industry needed a spurt,
They tore off a section of Jimmy's shirt.
Come, come away; it's too sad to stay,
But we must do something for Jimmy some day.
But what can we do ? Every Government plan
Finds Jimmy a quite superfluous man."

Stephen Leacock, Hellements of Hickonomics, (N.Y. 1936); pp. 30 & 31. Dodd, Mead & Co.

The Effect of Exchange Control on Import Restrictions

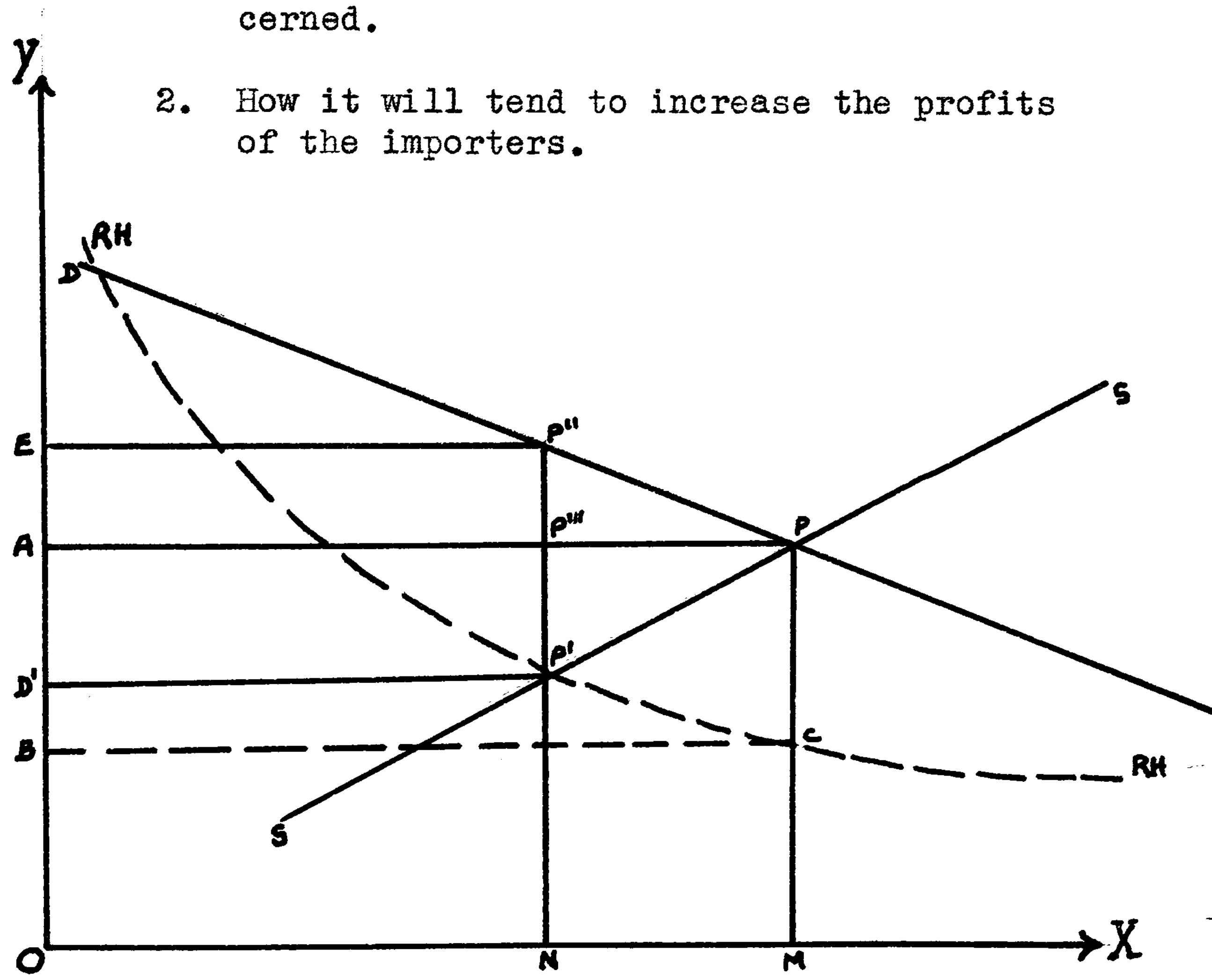
CHAPTER IV

THE EFFECT OF EXCHANGE CONTROL ON IMPORT RESTRICTIONS.(1)

Prices and production in exchange control areas are effected by the totality of restrictions on foreign exchange transactions and not only by those which control immediately the trade in commodities. We therefore have to use the available data with considerable caution. At the same time, credit expansions have been carried through in some of the countries under exchange control, the effects of which have increased the tendencies brought about by import restrictions. The two predominant ~~effects~~ problems of import control through exchange restrictions are:

1. How import restrictions through exchange control will tend to bring about the rise in the price of the commodity concerned.

2. How it will tend to increase the profits of the importers.



Quantities of imported products are measured along the X-axis, unit prices along the Y-axis. Curve D/D is the importers' demand curve. (It is derived from the demand curve of the consumers which lies above that of the importers).

(1) Cf Heuser pp. 206-208

S/S represents the supply of B product in country A alone. The curve is positively inclined indicating that country A is important enough to influence country B's supply price in country A. (This is Heuser's "great" assumption). Before restriction through exchange control A imported OM, price exhibited at P and OMPA is the rectangle which represents the amount of foreign exchange purchased on the free market.

Authorities reduce foreign exchange outlay by 50%, that is, to an amount represented by the rectangle OMCB; therefore exports cannot be larger than OMCB. The demand of importers therefore must move along a curve which passes through point C and for which XY is constant, that is the rectangular hyperbola RH. The new price which importers will have to pay will establish itself at P^1, that is the point where the new (artificial) demand curve meets the original supply curve. Quantity ON will now be imported, and since the area of rectangle D'P'NO is equal to that of rectangle BCMO, the amount of foreign exchange which has to be paid for the new quantity imported is equal to 50% of the value of the former quantity OM. But the fact that a restriction has been imposed on a commodity does not mean that the demand for it has declined. If the demand has been rendered stable, consumers as a whole will be willing to pay for P'' for the reduced quantity ON. A special profit equal to the area D'P'P''E will, therefore, accrue to importers as a group. This extra profit cannot be competed away, for the extra profit is not due to the issue of licenses but to the difference between the internal price - risen because of the reduction in supply - and the external price - fallen because of the reduction in demand.

It is important to note the assumptions upon which Heuser's analysis is based. His demand and supply curves are given. Now, if the demand curve is relatively elastic, prices and profits would not tend to rise so highly. But if the demand is inelastic, the rising profits may be even greater than Heuser points out. There are, nevertheless, certain compensating factors which would in all probability offset this tendency of profits to rise too readily.

Heuser himself points out that "the curve is positively inclined, indicating that "A" country is important enough to influence "B" country's supply price in country "A". This assumption in all probability will be relative to the marginal substitution costs of different commodities in the import country. The greater the substitution of the import restricted, the more difficult it will be to reap a windfall profit.

The profit margin will also be relative to the marginal producing cost of the commodity itself in the two countries. The smaller the deferential, the less the profit windfall.

The relative constant, increasing, or decreasing cost conditions in the two countries will also resolve upon the resultant. If the importing country is producing under decreasing cost conditions, the profit windfall will thereby be limited.

Again, the difficulty with Heuser's fixed demand and supply curves, is that during crises, exchange controls increase the costs of shipping, insurance, etc. The importer may therefore be compelled to pay higher prices and find it difficult to shift the incidence upon the consumer.

Although the rate of profit per unit may increase, the aggregate profit of the importer may very well decrease due to the curtailment of supply.

A restriction of imports may lead to higher quotations by the exporter, since a smaller quantity is being purchased.

We are led to the conclusion that on theoretical grounds, Heuser's categorical statement, "A special profit equal to the area D'P'P''E will therefore accrue to importers as a group" is unwarranted. It seems probable that in certain cases a windfall would set in, but there have been many cases in Canada where the importers lost, and lost heavily due to import restrictions through exchange control. Those who gained, were manufacturers who could produce substitute products.

Summarily if the curtailment in foreign exchange allocation results in a reduction in the imported quantity of the commodity:-

<u>A</u>. The consumer price will probably rise, and the extent of that rise will depend upon:

1. elastic or inelastic demand conditions.
2. increasing, decreasing, or constant supply costs.

3. the comparitive marginal differential in production.
4. the extent of imperfect competition in that industry.
5. substitution possibilities.

B. Importers will derive a special profit per unit if the legal reduction in the outlay necessitates a reduction in the imported quantity although the aggregate profit may be lower than it was before.

C. The larger the relative importance of the restricting country in the market of the commodity concerned, the greater will be the special profit, if no other outlets exist.

D. The increased unit profit on the restricted import products will remain as long as the difference between the domestic and the external price is maintained. In this case, as in all the previous ones, these results can only be ascertained by empirical investigations.

Exchange Control in

Austria

Austria

October 9, 1931 witnessed the first devisen law in Austria. The inevitable result of an increased velocity and quantity of money was the pronounced upward sweep in the Austrian sensitive-price index. It is important to notice that price equilibrium with gold countries, such as America, persisted from June to September, 1931, but that thereafter the official parity quotations on the schilling were maintained in the teeth of a decidedly adverse turn in purchasing power parity.

We can hardly question that a government must be ready to support the banking system when financial demoralization is imminent. Austria faced that situation in 1931. Devaluation was politically impossible. Out of the 850,000,000 schillings in National Bank Loans nearly 700,000,000 schillings represented frozen Credit Anstalt assets, leaving only 150,000,000 schillings which could be affected by the rediscount rate.[1]

After the collapse of the Credit Anstalt the Buresch cabinet was forced to coordinate its policy with that of the Socialists. The latter refused to accept deflation or devaluation as remedial measures. Exchange control was the only alternative, and the Constitutional Act of October 8, 1931, created the legal basis for subsequent exchange control by cabinet decree.

By this time Germany,[2] Hungary,[3] Czechoslovakia,[4] and

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[1] Ellis, op.cit., pp.34 and 35.

[2] July 13th.

[3] July 17th.

[4] October 2nd.

Yugoslavia[5], accounting together for 42% of Austria's exports and 52% of her imports, had adopted exchange control measures. These countries which absorbed half her exports and could no longer pay in devisen, were precisely the ones from which Austria had to derive her raw materials. Clearings commingled with devisen controls became indispensable. The League Report states that "it is only after careful consideration that the Austrian Government introduced these regulations; but no other course was possible, as practically all the neighbouring states were taking similar measures... No other step could be taken if the foreign exchange necessary for satisfying the urgent needs of the country for raw materials and foodstuffs and for meeting the foreign liabilities of Austria was to be secured."[6] The initial clearing arrangements were with Hungary, Switzerland, Italy and Jugoslavia.[7]

The first devisen act in many respects resembled that of other countries. The National Bank was empowered to monopolize devisen dealings, set the official rate of exchange, prohibit the publication of other rates and ration out devisen arbitrarily. Legislation was passed to curtail profit windfalls and commodity arbitrage. The stringent penalties for evasion were in no way commensurate with its possibilities. Defects in the system soon became apparent. Only three days after the inauguration of exchange control, exporters and transit firms were permitted to retain devisen necessary for purchasing raw materials

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[5] October 7th.

[6] League of Nations, M.Rost van Tonningen, "First Quarterly Report on the Financial Position of Austria," (Geneva, Jan.12,1932), p.10. Henceforth only the number of the report will be given. See index.

[7] Ibid., p.11.

and goods for re-export. Such transactions were to be examined by the National Bank. Like in Canada, insurance and income remittances were permitted; unlike Canada, bankruptcies rocketted. Evasion flourished and became the earmark of the entire system. On January 12, 1932, Tonningen writes that "an undoubtedly large contraband traffic in foreign currencies makes the forming of an exact appreciation of the effect of the currency regulations an extremely difficult matter."[8] Most of the "inward" contraband consisted in the buying of foreign securities at low rates abroad and selling them at high prices at home. Exports against schilling accounts continued.

Gradually the regulations became more stringent. The Fourth, and final, Devisen Act of January 4, 1932, explicitly limited exports against foreigners' schilling deposits to accounts which originated prior to October 9 or were especially designated as "free" by the National Bank. The bare legal framework of exchange control was now complemented by intricate administrative measures. It was soon discovered that the lax allocation of devisen did not leave enough foreign exchange for the importation of essential foodstuffs and raw materials. By January 9, 1932, 1700 firms were in the possession of import licences.

The entire exchange control system in Austria ended in a fiasco because of widespread legal and illegal evasion.

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[8] "First Quarterly Report," (Geneva)

"Black Bourse" operations flourished in Vienna cafés. A lively traffic in domestic currency sprang up in the border towns until the National Bank withdrew the issue of 1000 Schilling notes which had facilitated smuggling. Foreign sellers billed their Austrian buyers for spuriously large amounts and these invoices were subsequently utilized as an excessive claim for devisen allocation. A favourite device was to be billed for an import f.o.b. the foreign city of origin, whereas actually the importer had only to pay f.o.b. Austrian border. Another ruse was to induce foreign firms to send to Vienna their printed blanks for billing customers, or even to found in a foreign city a holding company to originate billing for goods which had never been imported. Firms within Austria enjoying the privilege of retaining export proceeds, used receipted import-duty bills in conjunction with these spurious billings to secure devisen which could then be applied to capital flight. Prior to the Fourth Devisen Act of January 4, 1932, when exports against payments in blocked schillings were commonly thought to be legalized, exporters drew upon foreign purchasers for payment in blocked schillings, secretly arranging for payment in devisen, which thus escaped control.

The "export against schilling" argument was hotly mooted in the press. Representatives of the National Bank maintained that this practice removed the control of imports from their hands and permitted a speculative market on blocked schillings abroad. This market was said to be narrow and subject to disastrous price declines from small decreases in demand.[9] There is no question that the extent to which schillings were accepted for requisite exports, the inflow of free devisen to the Bank was cut off.[10] The officials also argued that when control became imminent, many Austrians had transferred their bank accounts to foreigners in order to be able to send funds out of the country later. To permit their utilization now for exports would complete the intended capital flight by means of real goods. If exchange control was to be enforced, exports against schillings had to be disallowed. Nevertheless, "the total reduction (of foreigners' schilling deposits from November 30th, 1931, till August 31st, 1932), is 64.4 million schillings, notwithstanding the fact that new deposits of schillings were continuously being made during the period under review."[11] These huge withdrawals explain the adverse balance on capital account.

Only credit institutions were prohibited from transferring foreigners' accounts to residents without the permission of the National Bank. The Devisen Act of January 4, 1932, extended this ruling to all parties and thereby curtailed the lucrative business which many a lawyer drove with impunity by transferring accounts to third parties.

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[9] "Fourth Quarterly Report"(Geneva), p.10.

[10] The National Bank allowed the utilization of these free schilling balances of foreigners under three conditions:
(1) 12 per cent of the invoice price had to be paid in devisen.
(2) The invoice price had to be a "fair" or market value of the goods in question.
(3) "Exports can only be made to the country of domicile of the person. in whose name the schillings to be utilized have been deposited." Fourth Quarterly Report, p.32.

[11] "Fourth Quarterly Report"(Geneva), p.10.

Another channel of legal evasion was the purchase abroad and selling in Austria of internationally traded securities. The seller of a foreign security abroad was legally permitted to receive payment in blocked schillings which he could utilize in the purchase of Austrian securities, real estate, and even imports. As long as these blocked schillings were actually utilized by foreigners, the value of the currency was not actively depressed, aside from cases where payment would have been made in free devisen. When these proceeds remained, however, in blocked accounts, their growing magnitude drove down quotations on the schilling. By the end of October, 1931, the Vienna quotations on Austrian League of Nations bonds stood 20% above foreign quotations.[12]

The Fourth Devisen Act prohibited the acceptance of foreign securities in payment for exports. As a mode of capital flight, nevertheless, the practice continued till the ebbing days of exchange control. Only on April 5,1933, did the Finance Ministry prohibit dealings in favourite Swiss railway bonds. Enactments to prohibit purchases of foreign securities, or to end such practice by compulsory sale to the government was a logical complement to the compulsory sale of devisen. The failure of the Austrian authorities to embrace the entire gamut of international credit instruments resulted in a direct channel of capital flight.

The Second Quarterly Report[13] makes considerable mention of the indebtedness which had accummulated on account of Austrian

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[12] League of Nations Reports on Austria, Statistical Tables.

[13] "Second Quarterly Report" (Geneva), p.11.
From Oct.1931 till April 1932, 200,000,000 schillings of imports, or nearly half the aggregate of imports over exports were bought on credit.

purchases on credit (Warenkredite) since the introduction of exchange controls. These payments would ultimately have to be made, while the devisen receipts were steadily dwindling. The net result of the late[14] introduction of exchange control, the lax administration, and the power of exporting interests[15] was its almost complete failure to secure the devisen yielded by exports.[16] For the first month in operation only one-fifth of the exports yielded devisen.[17]

Rationing of exchange became more "stringent." "The National Bank has reduced the allocation and requisition of foreign exchange to importers and from exporters."[18] In the three months October 10 to December 31, 1931, devisen allocated was 176.9 million schillings; the quarter beginning in July and ending in September 1932 witnessed the disbursement of only 49 million schillings. There was therefore a drop of 72.25% in the devisen allocated. Similarly, there was a reduction of 69.5% in the devisen received.[19]

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14 On May the 8th, when the Credit Anstalt failed; on July 13th, when Germany established controls; or at least on September 21st, when England devalued, was the time to adopt devisen controls instead of waiting till October 9,1931.

15 "Fourth Quarterly Report", (Geneva), p.19. "Austria is especially interested in widening the market for manufactured goods, which, in 1931, accounted for over 80% of her export." It was these industrial exporting interests who suffered most on account of the overvalued currency and clamored for the abrogation of the controls.

16 "Third Quarterly Report," (Geneva), p.10 "The foreign exchange became increasingly inadequate to satisfy the requirements of the import trade and of the foreign debt service."

17 Ibid., p.9.

18 "Fourth Quarterly Report," (Geneva), Nov.30,1932, p.8.

19 Ibid., Appendix 4, drawn up by M.Maurice Frère.

The short interval (October 1931-February 1932) which witnessed the existence of exchange control in Austria was one of international malaise. It is, therefore, impossible to measure the influence which the technique itself had upon internal economy. In general, agriculture suffered less at the expense of industrial exports. The technical inefficiency of the system was largely the cause of its breakdown, and the overvalued schilling aggravated the export position of industry, clogging the barrier stricken market even still more.

How Austria Escaped from Exchange Control.

M. Rost van Tonningen points out in the Third[20] and Fourth[21] Quarterly Reports that Austrian policy from the start aimed at liberating itself from exchange control and inter-state clearing agreements. As "Austria must be considered entirely dependent upon exports for the prosperity of its forests,"[22] it is not surprising that the first subtle approach toward liberating payments came from that direction. The National Bank came to the rescue of the industry (80% of the sawmills were dormant), by permitting Austrian exporters of all wood products to sell their

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[20] "Third Quarterly Report,"(Geneva), p.14.

[21] "Fourth Quarterly Report,"(Geneva), Nov.30, 1932, p.11.

[22] "Fifth Quarterly Report,"p.12.

devisen at rates privately agreed upon to importers of mineral oils. Such coupling of specific exports and imports came by degrees and was gradually extended. The important thing is that the exchange rates in these cases were not determined by the National Bank but solely by pairs of contracting parties. It is not to be assumed, however, that the disruptive forces of laissez-faire competition were permitted to play havoc with the economy. "The National Bank retained the right of general supervision and approval. The management of the Kassenverein.. also endeavoured to render the system more flexible [and it] is thus gradually approaching the border line of a free exchange market, though still supervised and regulated by the rules laid down by the management."[23] The varying percentages of devisen which were to be handed over to the Bank plus the isolated pairing of imports and exports resulted in an agios of quotations, for one and the same foreign currency. Private clearings increased in the last quarter of 1932[24] and by the end of that year, "allocations of foreign means of payment by the National Bank to traders had entirely ceased. Finally, on April 6, 1933, the National Bank freed all persons"[25] from the obligation of delivering devisen to the Bank. From that date onwards the only significant rate of exchange in Austria was that fixed by the Clearing House on the basis of free transactions. This became possible because: (1) the clearing agreements contracted up to the spring of 1932 were term-

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[23]"Fourth Quarterly Report,"p.11. Our italics.

[24]"Fifth Quarterly Report,"p.8.

[25]"Sixth Quarterly Report,"p.9.

inated; (2) the allocation of devisen by the Bank and remittances to it by exporters was gradually abrogated; (3) the frozen accounts or "Sperrkonti" were liquidated and became applicable for a variety of domestic uses; (4) budgetary equilibrium was established; (5) the agreement with the foreign creditors of the Creditanstalt was ratified and (6) Austria's foreign indebtedness was reduced by the American devaluation and the League of Nations conversions into lower rates of interest.[26] The freedom of movement in the international sphere was thereby widened. "Signal proof of the inherent strength of the Schilling was afforded by the improvement in the exchanges which followed this decision, rates moving upwards by about 3 per cent."[27] It is interesting to note that the devaluation of the schilling was in operation "de facto" long before "de juré". This was initially due to the blocked foreign debts and the psychological fear of panic inflation. In December, 1931, the price of gold reached a peak of 142% of par. Like in Canada, during the first year of control, this excessive depreciation was largely due to the pressure of capital flight carrying foreign exchange values beyond purchasing power parity. In the long run, however, the foreign value of the schilling was a function of the relative movements of production and money. The price of gold in Vienna by July 1933 was 128% of par.[28] Production on the other hand

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[26] "Second, Third, Fourth, Fifth and Sixth Quarterly Reports on Austria's Financial Position." Section IV. Central Bank Position.

[27] "Sixth Quarterly Report," p.9.

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Gold Prices in Per Cent of Parity

	1931	1932	1933
Sept.	100	120	128
October	122	120	128
November	130	120	128
December	140	120	128

Source:Ellis, op.cit., p.360. Statistical Tables. Also p.64.

dropped from 79 in April 1931, (just prior to the Creditanstalt catastrophe), to 64 [29] in July, 1933. As the total amount of money remained at approximately the same level during the two periods,[30] the price of gold is almost the exact reciprocal of the index of production. The differential is only 3 per cent and this clearly shows that the value of the schilling lived up to the expectations of our theoretical premises: rulers are not masters over the exchanges.

Once the devaluation was legally recognized, however, the expected rise in the internal price level did not occur.[31] Austria's economic position strengthened continuously from March, 1933, until her incorporation into Germany on May 12, 1938.[32] Professor Ellis, therefore, concludes that "Austria was able, by <u>virtue of the abandonment of the official Schilling parity and the rationing of devisen</u>, to escape with a penalty upon its foreign trade slightly less than that imposed by more autarchic countries."[33] Although one disagrees with an authority like Professor Ellis with diffidence, it seems that in one case he doesn't "prove" enough and in the other he "proves" too much. Just because foreign exchange control was abrogated in 1933 and Austria "was unique in being able to secure short-term

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[29] "Quarterly Reports."

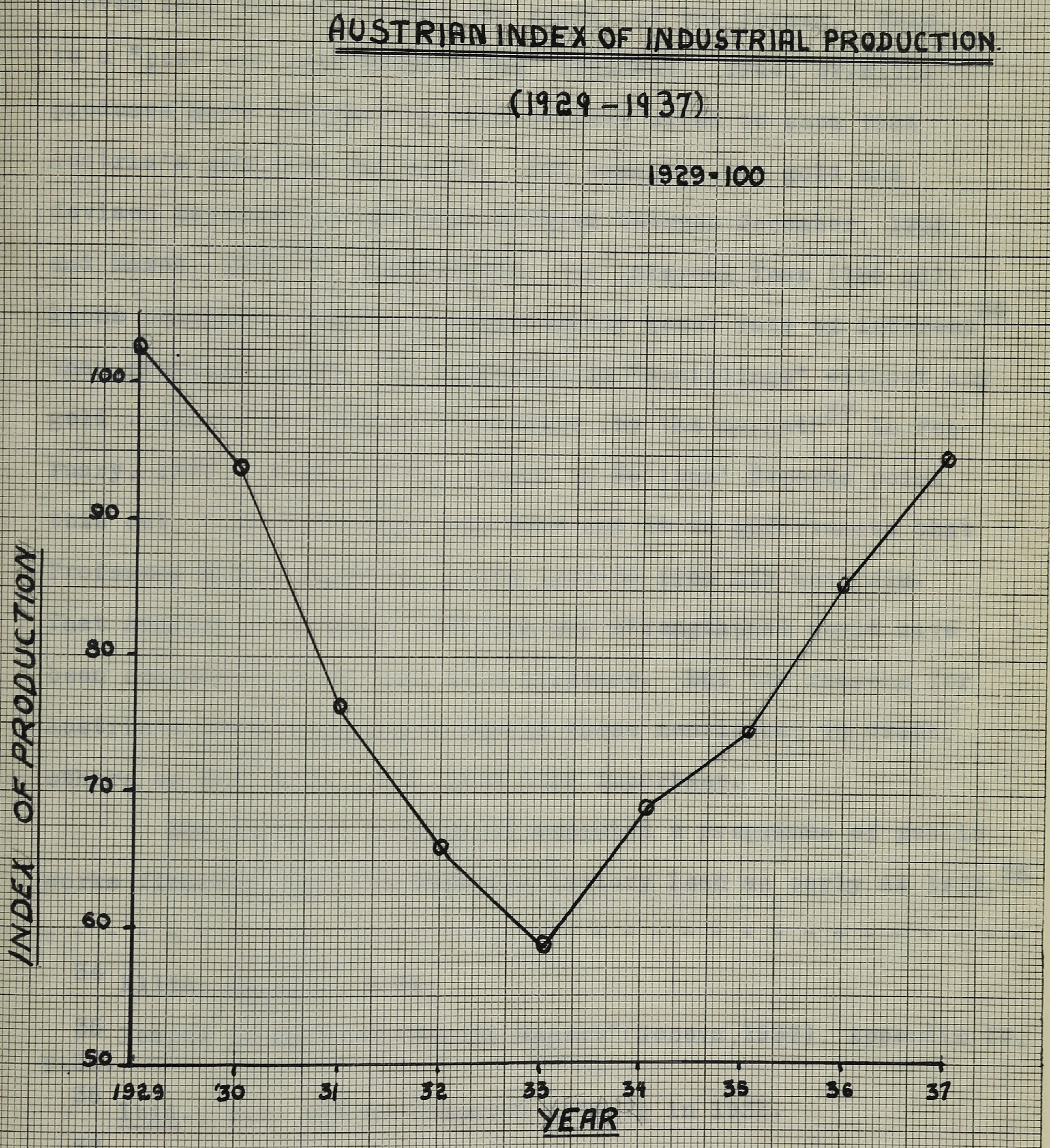
[30] Central Bank sight liabilities and notes remained around 100,000,000 pengos.

[31] "Seventh Quarterly Report," p.9. The devaluation occurred on March 23rd and April 26th, 1933.

[32] See chart. No 3

[33] Ellis, <u>op.cit.</u>, p.62.

No. 3.



SOURCE: LEAGUE OF NATIONS QUARTERLY REPORTS (APR.-AUG. '37) commercial credits on the London market"[34] in 1936 hardly proves that the latter was the result of the former. This is a "post hoc ergo propter hoc" argument. True, Dr.Ellis produces more information than we have cited to show that Austria's position was sound. For example, the gold and devisen reserves of the Bank doubled between December, 1932, and March, 1937.[35] Furthermore, "an internal loan (180 millions nominal) carrying a considerably lower rate of interest[36] than previous loans, and expressed in "schillings" without any gold ..clause was entirely absorbed..by the market"[37] in February, 1937. Although the League of Nations' Reports point this out, they also show much more and it is unfortunate that Professor Ellis omits the years 1933-36 from his analysis. That Austria's economic position was strengthened would have been corroborated by even more evidence. But the reasons for Austria's upswing were not merely those mentioned; in truth, others, on the whole, seem even more important.

The Austrian Government executed a programme of public works financed from the domestic Lottery Loan as early as 1933.[38]

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[34] Ellis, op.cit., p.55.

[35] League of Nations,"Second Report"(Geneva,1937), Appendix IV, p.32.

[36] Ibid., p.4. 4½% as compared with 7½ in 1931.

[37] League of Nations:"Financial Committee, Report to the Council on the work of the 64th Session of the Committee,"May 11, 1937.

[38] Ibid. "Report to the Council on the work of the 54th Session of the Committee." May 14, 1934, p.2.

Such measures, commingled with the re-organization of the banking system[39] and the reduction in the rate of interest, stimulated the internal market. More important, the revival in the export industries,[40] accelerated by good crops[41] and "sounder" commercial as well as political relations with Italy, Hungary and Yugoslavia, played the decisive role.[42] The German New Deal started many a machine rolling in Austria.[43] "Exports of paper pulp rose from 77,143 tons to 87,043 tons, and of iron ore from 10 tons to 33,554 tons, almost entirely to Germany and Czechoslovakia."[44] On August 10, 1934, a clearing agreement with Germany entered into force to increase trade between the two countries. The League Report in December, 1934, states "that this increased activity mainly relates to foreign markets, as effective domestic purchasing power has not yet noticeably increased."[45] This channelizing of trade into clearing countries and what Einzig has later called the German "Bloodless Invasion"[46]

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39 "Eleventh Quarterly Report," p.8.

40 Ibid., p.13, also later Reports. Section on Foreign Trade.

41 "Eleventh Quarterly Report," p.12.

42 Ibid., p.14.

43 "Twelfth Quarterly Report," p.12.

44 Ibid., p.8.

45 "Thirteenth Quarterly Report," p.17.

46 Einzig, The Bloodless Invasion, (London) 1939.

began long before the inauguration of exchange control. Germany has been Austria's chief customer since 1927. By 1938 Italy challenged that position and Hungary came next in line.[47] The non-clearing countries,[48] on the other hand, declined in importance as buyers of Austrian goods. Their stock of imports from Austria fell by volume from 36.4% to 18.6%, and by value from 46.1% to 45.7%. This has been a secular trend since the World War. And although there were rivalries between the clearing countries themselves,[49] economically, the "camps" were being lined up long before 1939. M.Pflugl, the Austrian representative to the League of Nations on sanctions, proclaimed that "the ties which unite the Austrian people to the people of Italy are strong, and Austria will not be disloyal to a friendship destined to last far into the future."[50] There was, of course, no question of sentiment involved but sheer political and commercial "prudence."[51]

Austria's strengthened position was, therefore, more the result of secular external economics commingled with internal

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47 cf.Composition of German foreign trade,"Statistisches Jahrbuch."

48 Chiefly U.S.A., Netherlands, France and United Kingdom.

49 cf.Austria and Germany; Italy and Germany prior to the Abyssinian War, etc.

50 cf."League of Nations, Official Journal," Special Supplement No.138, Oct.9, 1935, p.101.

51 Ibid., Special Supplement No.145, p.74. It may be recalled that in 1934 Italy mobilized and armed the Brenner Pass, warning Germany to keep hands off Austria. Hungary, Austria and Albania were the only three countries which refused to apply sanctions.

New Deal revival,[52] than the liberation of the exchanges. The latter may have aided the general recovery but it certainly cannot be called the causal factor. Neither can we undermine the absolute rise in Austrian foreign trade relative to her small national income.[53]

It is very important to notice that although the League of Nations' representative, the Austrian Institute for Trade Cycle Research and the Chamber of Commerce unanimously deprecated the "cumbersome nuisance" of exchange control, it was never wholly removed. And we must sympathize with the cautious course taken by the National Bank.

The incorporation of Austria into the German exchange control system proceeded very tentatively. On December 12, 1938, nine months after the political change, a general recodification of devisen laws absorbed the Austrian modicum of control into the German hierarchy. Gradually, but with ruthless efficiency, evasion

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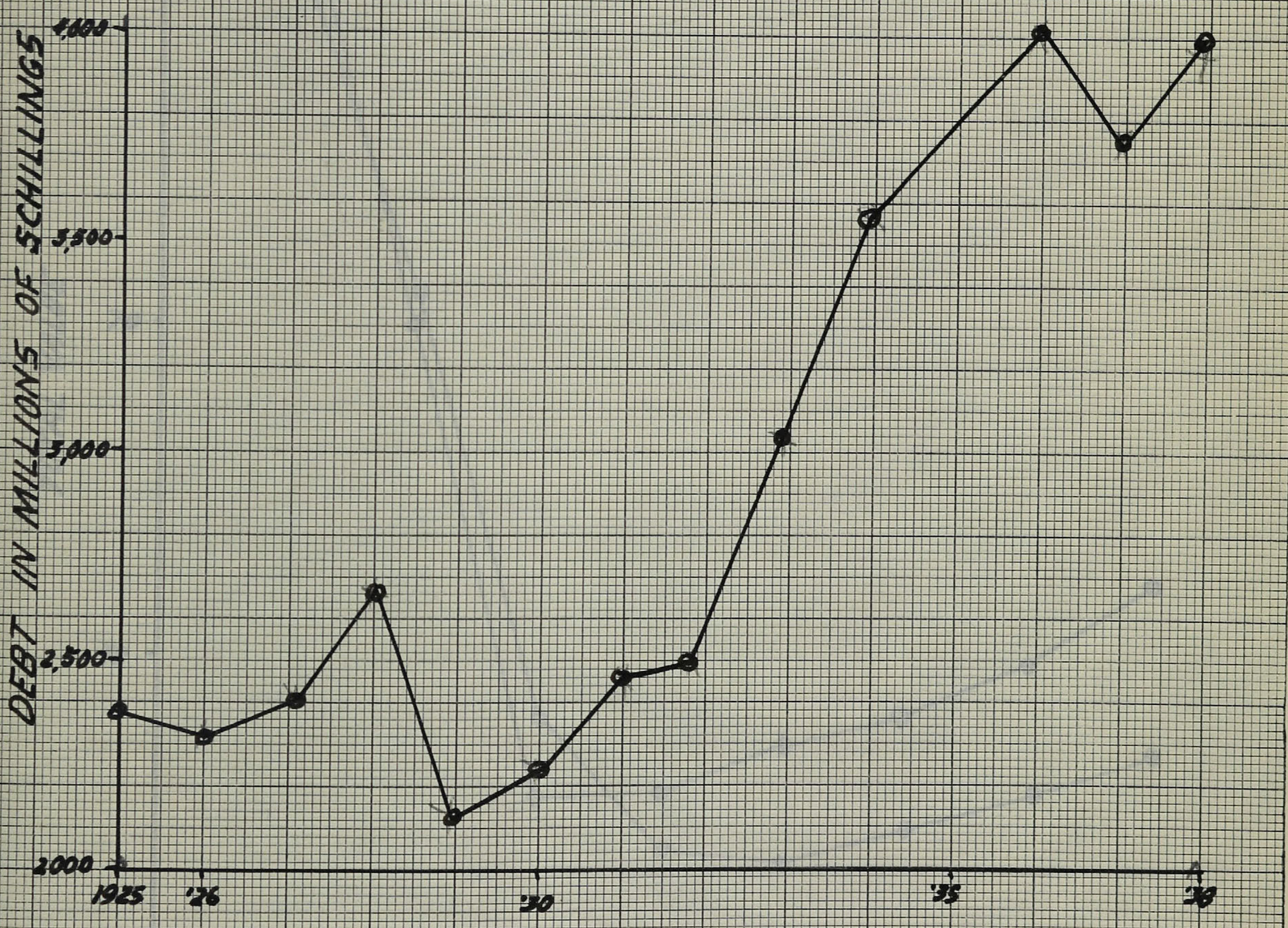
[52] Chart No. IV shows the development of the State's total debt which was closely connected with public expenditures. This graph reveals that the total debt rose continuously and reached its maximum for the period at the beginning of 1936. The drop in the course of that year was due to the foreign devaluations. Since then, the index has risen steadily.

In the course of thirteen years (1925-1938) the internal debt increased from 396 to 2,208 million schillings. The total foreign debt decreased from 1,971.3 to 1,715.1 million shillings. League of Nations:"Austria, Public Finances." Second Report, Nov. 1936-Mar.1937, p.14. "In considering the debt situation, it should be borne in mind that the Austrian government is <u>engaged in public works</u>, such as the modernization of motor roads and the electrification of the railways, the completion of which would seem to require further credit operations." <u>Ibid.</u>, p.14.

[53] See chart. V

No IV.

TOTAL DEBT POSITION (AUSTRIA)



SOURCE: LEAGUE OF NATIONS QUARTERLY REPORTS (NOV '26 - MAR '37) was minimized, prices and production were geared into line, tariff barriers were removed, creditors appeased[54] and autarchic control was established. The evolution of this "airtight" system of exchange control in Germany will be examined in Chapter VII.

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54 It is interesting to note that English creditors fared best with full servicing of the loans 1933-53 and 1934-59.

Exchange Control in Hungary

CHAPTER VI

Hungary

Hungary is a country whose prosperity is dependent upon the export surplus of her agricultural staples.[1] Like other heavily indebted European states in 1931,[2] she found exchange control to be a necessity in coping with capital flight. A concourse of circumstances made the international economic crisis weigh particularly heavy upon her depressed trade. "A country which had borrowed freely from abroad for years, found itself cut off from foreign credit at a time when its exports were experiencing greater and greater difficulties in finding a market and when the prices of these exports were sinking to an extent that was far from being compensated by decreases in the price of the main Hungarian imports. Moreover, the 1931 harvest was a poor one - worse in Hungary than in neighbouring countries."[3] Professor Fellner estimates the national income per capita for that year at 360 pengo, as against an average of 514 pengo for the four years 1926-1929.[4] In spite of these difficulties, the League representative claims that Hungary had great economic reserves and her policy of industrial protection followed since the war "might with advantage be reconsidered,

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1 "First Quarterly Report on the Financial Position of Hungary", Jan.12, 1932, p.10.

2 "The total annual charge in respect of Hungary's foreign debts, short and long term, has been estimated at approximately 300 million pengo." Ibid.

3 Ibid., page 10.

4 Ibid., page 10.

especially in connection with plans for restoring to Hungarian agriculture its traditional markets."[5] The historicity of the Hungarian crisis may have many similarities with the Canadian post war situation.

From July 17th, 1931,[6] to December 1st, 1932 [7] a fairly liberal application of the official pengo rate was maintained. The sporadic deviations assumed the aspect of authorized exceptions or illegal evasions. In general, the initial regulations were in no way strikingly novel. Imports as well as exports came into the permit orbit. The "Gold-Pengo Law"[8] embraced all former debts (including bank deposits), obligations to the state and future contracts. This obligation to pay in gold pengo had for the moment a beneficent effect. Rumours in September, 1932, that the National Bank would publish a gold-paper ratio produced a run <u>into</u> the banks.[9] Sensitive, wholesale and retail prices rose from the second quarter in 1931 till the end of that year. This tendency in the face of sharply declining prices abroad reflects a rapid depreciation of the real currency value. In the same period the sterling-bloc devalued and the relative deflationary tendencies in Czechoslovakia, Switzerland and Germany left the pengo "high and dry". The overvalued pengo reduced exports, which fell

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[5] "First Quarterly Report on the Financial Position of Hungary", page 10.

[6] <u>Ibid.</u>, page 9.(Full foreign exchange control on August 8,1931. "Fourth Quarterly Report," p.13).

[7] "Seventh Quarterly Report," p.11.

[8] "First Quarterly Report," page 8.

[9] <u>Ibid.</u>, page 22.

on a curtailed and sagging market.[10]

"In the case of foreign trade, inland prices are so high that Hungarian wheat cannot at present be sold at Antwerp or Rotterdam without considerable loss, if the price obtained is converted into pengo at the official rate. The problem of meeting this loss is an embarrassing one, and increases the inducement to dispose of an ever-greater part of Hungary's agricultural exports by complicated arrangements which have the apparent advantage of not interfering with the artificial price which it is desired to ensure to the grower, and the real drawback of bringing no Edeldevisen to the National Bank".[11]

Devisen reserves became more and more deplete. This resulted in a limited allocation of foreign exchange for import purposes and afforded protection to certain industries from foreign competition. Cartelized industry boomed at the expense of the consumer. "The Hungarian Fiscal System was built up on taxes affecting consumption and that consumption has fallen off, a dangerous condition of prolonged budgetary disequilibrium being the result. A disparity such as exists in Hungary between the prices actually obtained by the producer for most agricultural produce and industrial prices, mostly cartel-controlled (Agrarshere), must detract heavily from the purchasing and taxpaying power of the agricultural population."[12] It is, therefore, not surprising that the Hungarian excess of exports fell from 88,300,000 pengo in 1930 to 31,000,000 pengo in 1931.[13] Once more we note the

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10 The price of Hungarian wheat fell 14%, in this interval, on Hamburg and Liverpool markets.

11 League of Nations: "Seventh Quarterly Report on Hungary",p.14.

12 Ibid., p.14.

13 League of Nations, "Quarterly Reports,"Section II. Trade. Chart No.

futility of a deflationary policy under circumstances of this sort. We have seen[14] that Hungary's annual debt approximated 300,000,000 pengo; it is ludicrous to imagine that an export surplus amounting to 10 per cent of this amount could be increased tenfold through monetary policies. Moratoria to prevent foreign capital flight and exchange controls to prevent national capital flight were therefore essential.

Slowly but surely the "agricultural price shears" reduced the agrarian classes to desperate straits. The discrepancy between free and bound prices became more pronounced.[15]

A scheme was started on December 1, 1932, for helping exporters to overcome the differential between internal and external prices. "Under this scheme, the exporters of certain articles receive a variable premium in addition to the pengo parity equivalent of foreign exchange which they surrender to the National Bank, and this foreign exchange, with *certain deductions* for the National Bank, is allotted to importers of raw materials at a rate involving a *surcharge* over and above the parity of exchange."[16] December, 1933, witnessed a widespread recognition of these non-par rates in the form of an enormously complex array of differential premia and

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[14] League of Nations, "First Quarterly Report on Hungary", p.9.

[15] Free price index (1927 equals 100) shows a decline to 63.2, i.e. almost as low as agricultural prices. The sticky industrial price index or those determined by cartels had risen to 105. "Fourth Quarterly Report", p.15.

[16] "Seventh Quarterly Report", p.11., our italics.

surcharges.[17] The system of running accounts, which was also introduced in Canada, obviated the necessity of a strict balancing of each separate transaction. The latter, more meticulous scheme, like in our own country, was attempted and found impracticable. Imports from Germany paid an 18% surcharge for raw materials, 22% for half-finished goods and 25% for finished goods. Imports from other clearing countries bore about the same rates, with the exception of Austria, for which the old gold parity was maintained. The entire multiple rate scheme was based on the theory that in Hungary's particular situation, price discrimination would yield a larger return than uniformity. The rates of premium were calculated separately on each description of goods, and varied considerably from one case to another. During this period, agrarian prices were depressed and still sinking. Many classes of goods could still be exported profitably, without a premium; others required a small impetus; while still others necessitated a relatively high premium. "In the circumstances, it was held that any flat rate of premium, in order to suffice all round, would have to be much higher on the bulk of exports than that actually needed on many descriptions of goods, thus exposing the internal purchasing power of the currency to an unnecessary strain."[18] Hungary also desired to apply higher premia to exports for which freely available currencies

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[17] The average premia and surcharges for the months
Feb. to Sept. 1933 were 13.4 to 16.9%.
Jan. 1934 averages stood at 17.9 and 22.9%.
Jan. 1935 " " " 23.2 and 27.0%.
During the course of 1935 the premia and the surcharges declined to bring them to the same level at 25%, when the differential system was terminated.

[18] "Seventeenth Quarterly Report", p.10.

could be obtained. As might very well be expected, industrial cartels fared better than unorganized, smaller, competitive industries in securing certificates for the retention of devisen and in obtaining allocations for raw material imports. To offset these buttressing forces on monopoly price, on December 1, 1932, manufacturers and importers were required "to give an undertaking in writing that (they would not) increase their prices."[19]

Professor Ellis states that "in a period of generally falling prices, such a measure would, of course, be purely nugatory."[20] This hardly seems to be true. The important factor at this time was the scarcity in devisen. This led, in many cases, to the purchase of foreign exchange at higher rates on the open market and, therefore, to higher prices. The new arrangement was to encourage, as far as possible, the <u>reduction</u> of industrial prices in Hungary, which were higher than they were before the war.[21] It must also be remembered that the pengo was still overvalued and exchange control operated in conjunction with import quotas, tariffs, export monopolies and credit controls to lower industrial costs, raise internal agricultural prices and still maintain an export surplus through differential rates. The entire economy was, therefore, directed (and to a large extent insulated) from external factors. Conditions of this sort permit price discrepancies even though world prices are on the decline.

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19 "Fifth Quarterly Report", p.10.

20 Ellis, <u>op.cit.</u>, p.99.

21 "Fifth Quarterly Report", p.10.

Once exchanges are controlled, devisen receipts soon have to be allocated. Production, therefore, becomes selective. And the planning of production necessitates price controls. It is apparent that control of the exchanges gradually led to the control of the entire economy.

Little by little, conditions in Hungary changed, making reconsideration of the premium system advisable.[22] As we have seen, the fact of overwhelming importance during the whole period of depression was the opening of the "agricultural price shears." On the one hand prices, particularly bound prices, were kept artificially high through tariffs, quotas and exchange control, on the other hand, the balance of trade was being further throttled by the overvalued pengo. In the fourth quarter of 1935, the external exchange value of the pengo steadied.[23] The agricultural "price shears" began to close[24] and the National Bank was able to provide an increasing scale for importers' exchange requirements. The inducements to maintain a variable system disappeared, while drawbacks in the shape of uncertainty, complication and intereference with the established course of trade and production became increasingly obvious.[25] The management of the National Bank, after consulting the relative departments, decided to go over to a flat rate system, both as to goods and as to countries. These rates varied, however, as between countries

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[22] "Seventeenth Quarterly Report", p.10.

[23] Ibid., p.10.

[24] Ibid., p.10.

[25] Ibid., p.11.

with which Hungary had clearing agreements and those with which she had none.[26] The reduction and simplifications which followed consummated in the complete recasting of the standstill and the gradual removal of the moratoria in 1937.[27] The last phase of foreign exchange control extending from mid-1937 until the outbreak of war involves a somewhat milder form of exchange control with fairly effective transfer of the debt service in free exchange.

Professor Ellis states that "the isolation of exchange control as peculiarly responsible for the throttling of industrial production in the first half of 1931 has some justification, inasmuch as the upturn in the second half of the year was accompanied...by increasing departures from the official pengo prices."[28] This is hardly a scientific conclusion. The possibility is that exchange control did hamper certain selective industries but it is very difficult to imagine that conditions would have improved had controls not existed. In truth, the writer would conjecture that the opposite is true. Furthermore, it is very difficult to find this "upturn." Mr. Tyler writes, in the first quarter of 1933, that "the indices and returns illustrative of internal business trends do not indicate any improvement; here and there perhaps there is a slowing-down of the rate of deterioration.[29] Furthermore, the revival began in the consumers' goods industries and the process afterwards spread to producers' goods.[30] It seems

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26 "Seventeenth Quarterly Report", p.10.:"Before the unification of Premia, the variable rates applied in the case of clearing countries averaged about 23% and, in the case of non-clearing countries, about 38%."

27 "Twenty-third Quarterly Report", section 5, pages 12-16, also "Twenty-Fourth Quarterly Report," pages 8-10.

28 Ellis, op.cit., page 96.

29 "Sixth Quarterly Report," p.2.

30 The trade treaty signed with Austria and Czechoslovakia was no doubt a beneficient fact."Seventeenth Quarterly Report,"p.11.

logical to assume that the revival was primarily a function of internal resuscitation commingled with commercial policy and better conditions in Hungary's trading partners.

That the premiums also stimulated business with non-clearing countries can hardly be questioned. But the long run effects which these bounties produced probably outweighed their temporary stimulus.

1. Once in existence, bounties established margins of cultivation and production which are dependent upon these premiums. Hungary found that the removal of these bounties becomes impossible.

2. Factors of production which are absorbed into the subsidized export industries raised the cost of other export commodities. (This argument must be qualified when unused factors exist.)

3. The price of what Harrod calls (D)[31] goods, or those which do not enter international trade also rise. The foreign value of the currency is, therefore, maintained at a level higher than can be justified on the basis of comparative costs of production.

One thing is certain: if deflation could not ameliorate Hungary's position, an expansionary monetary policy could do no better. A small agricultural country, dependent upon staple exports sold on world markets, cannot solve her difficulties through monetary tricks. Credit expansion, in Keynesian analysis, would not absorb new factors of production but would only result in higher money costs and depress the foreign value of the currency. Canada's economy, in this respect, resembles that of Hungary It

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31 R.F.Harrod, International Economics, London, 1933, p.110.

is important to note that monetary policy, be it highly orthodox or revolutionary, cannot be generalized and must always be analyzed in conjunction with the relative economy. The simplified premium and surcharge scheme which followed involved five main categories:[32]

Category	Premia for Export	Surcharges for Import
(1) Clearing Countries except Austria...	38%	41%
(2) Foreign Exchange Countries....... .	50%	53%
(3) "Devisen-compensation" as applied to Germany................	18%	19%
(4) Austria............................	10%	13%
(5) Compensation Countries..............	ad hoc	ad hoc

It is self-explanatory that the premia for exports to "free" countries should be higher than those issued for exports to clearing countries. The differentials, by and large, varied relative to price discrepancies on the one hand and the possibility of spatial and geographic monopoly on the other. "Despite undoubted benefits to the volume of foreign trade attending the rate simplification of early 1936, Hungary made slight progress during the year on other methods of simplifying or reducing exchange control, largely because of uncertainties preceding the gold-bloc devaluations."[33] Again the writer is weary of the close connection between the relative liberation of the exchanges and the improved conditions in foreign trade. The tendency can only be analysed fairly in conjunction with all the other intern-

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[32]"Seventeenth Quarterly Report," pp.1 and 10. The table used is that given by Prof.Ellis, op.cit., p.86.

[33] Ellis, op.cit., p.88., our italics.

al as well as external factors. True, several indices in the last quarter of 1935 pointed to increased economic activity.[34] The quantum of exports, nevertheless, was slightly smaller than in 1934. Hungary's exports to Germany and Italy began to mount. This had nothing to do with the freedom or control of exchanges. Germany's New Deal had begun; Italy's venture to Abyssinia was afoot. Mr.Velics, Hungary's representative to the Committee on Sanctions, refused to curtail exports to that country and shipments rocketted. He claimed that "the exclusion of Italy from Hungary's restricted and limited trade outlets would completely upset our economic and financial equilibrium."[35] The turnover, in values, of Hungary's foreign trade in the January-March quarter 1936, was 12% higher than that of the previous year.[36] It is important to note that "the increase is mostly in transactions giving rise to no available exchange."[37] On March 24, 1936, three protocols, additional to the Rome agreements of 1934, were signed by the Prime Ministers of Italy, Hungary and Austria.[38] The contracting parties undertook: 1."in all spheres to harmonise their action with whatever developments the European situation may produce,...to create a permanent organism of reciprocal consultation to this end; 2.to engage in no important political negotiations referring to the Danubian question

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[34] "Seventeenth Quarterly Report", page 11.

[35] "League of Nations, Official Journal," Special Supplements No.138, p.102.

[36] "Eighteenth Quarterly Report," p.2.

[37] Ibid., p.2.

[38] "Tenth Quarterly Report", p.18. "Eleventh Quarterly Report",p.14.

without previous consultation among themselves."[39] It is no accident that these three countries belonged to the "revisionist bloc" in Europe. The political re-alignment is glaring and fits into our secular scheme. Mr.Royall Tyler concedes that the measures unifying exchange premia and surcharges made for some improvement in the Bank's foreign exchange position.[40] But this improvement must largely be attributed to the secular and political factors tied up with world agricultural recovery.[41] The League Representative writes as follows: "The 1936 harvest has resulted in an appreciable increase in exports... A large part of Hungary's exports has, moreover, to be marketed in countries whose currency is of limited availability."[42]

The gold-bloc devaluations in late September,1936, necessitated an alteration in the rates of premia and surcharges. Since prices in the "gold-bloc countries" were relatively low, the "de facto" devaluation of the pengo was now negligible. Although Professor Ellis argues that the comparative cost indices warranted a greater "devaluation" on behalf of Hungary,[43] still, "the export surplus for the first nine months of 1936 (was) much the largest recorded for any corresponding period for many years past."[44] The direction of this trade is noteworthy:[45]

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39 "Eighteenth Quarterly Report", p.17.

40 "Nineteenth Quarterly Report", p.9.

41 "Twentieth Quarterly Report, p.9. "Twenty-Second Quarterly Report", p.2. Advance seems to have been in consumers' goods.

42 "Twenty-First Quarterly Report," p.3.

43 Ibid., p.88.

44 "Twenty-Fourth Quarterly Report," p.11. The interval from early 1936 to mid-1937 also witnessed the institution of devisen payments with France, Belgium, and Switzerland.

45 Ibid., p.11.

	Hungary's Imports		Hungary's Exports x)	
	av.1925-1930	1st.8 mos.1937	av.1925-1930	1st.8 mos.1937
Austria	16.7%	18.09%	32.9%	17.22%
Italy	4.6%	6.81%	6.4%	14.43%
Germany	18.6%	26.28%	11.7%	23.45%

In the first quarter of 1939 Germany took 95% of Hungarian meat export, 88% of the hogs and 75% of the grain.

These figures once more bear the conclusion that Hungary was gradually falling into the "axis" camp. The drop in exports to Austria is due to a conglomeration of reasons, but the fact that Austria feared Germany's expansion and, therefore, leaned over to France and the other "free" countries may explain the tendency in part.

The recession which set in at the close of 1937 marks the last phase of Hungarian exchange control. Wheat prices in world markets sagged and Hungarian industrial production fell off 15% from 1937 to 1938. The Austrian Anschluss and the Czechoslovakian crisis introduced the "War of nerves." Flight of capital into real values, and, whenever possible abroad, wrought havoc with the economy. The National Bank Statute was revised on June 23, 1938. The "New Deal" expenditures mounted. As early as April, 1937, the state planned investment programmes. "The Finance Minister, in presenting his budget, made it clear that social considerations had led the Government to include in these programmes public works such as road-building and water-course regulation, which are of general utility but are primarily intended to relieve agrarian unemployment."[46] Hungary's Five Year Plan allocated 1,000,000,000 pengo

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46 "Twenty-Second Quarterly Report", p.12.
x) "Twenty-fourth Quarterly Report", p.11.

for state expenditures. Of this amount 600,000,000 pengo had been set aside for rearmament and 400,000,000 pengo for public works. By the late spring of 1939 half of this sum had already been spent.[47] That the value of the foreign currency chiefly depends upon relative production and "money on the wing" indices was clearly evident by Zurich pengo quotations. These quotations fell during 1938 and the early months of 1939 from 60% to 30%.[48] On January 15, 1939, the depreciation of the pengo was recognized "de juré" in a formal revaluation of National Bank gold and devisen reserves by 50%, corresponding to premia paid on free devisen. The recession was short-lived and industrial production rebounded from 116.2 in the second quarter of 1937 to 147.0 in the first quarter of 1939[49] Germany's war economy largely ruled the destiny of Central Europe.

The period under study was characterized by two predominant factors: the secular development toward autarchy and the trend of world agricultural depression and revival.[50] Hungary's economy was a sine function of these pulls. To deal effectively with capital flight, foreign indebtedness and the crisis of "simpler foodstuffs" in 1931, the control of the exchanges was an indispensable technique. It was a necessary spoke in the

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47 Royal Institute of International Affairs, South-Eastern Europe: A Political and Economic Survey. London, 1939, p.118.

48 "Quarterly Reports," Statistical Tables.

49 See ~~chart No~~. Ellis, Statistical Tables

50 Hungarian industrial activity fell less than that of most countries and recovered more; Hungary's foreign trade declined more than that of most countries and recovered less.
a) League of Nations, World Economic Survey, 1936-1937 (Geneva, 1937) p.76.
b) Ibid., World Economic Survey, 1937-1938 (Geneva, 1938), p.120. cf.also "Quarterly Reports."

entire Neo-Mercantilist development. And its inauguration in 1931 merely intensified a pre-existing trend. The influence which exchange control had separately is incommensurable and must be analysed in conjunction with all the other disturbing factors in Hungary's economy. Capital flight was harnessed. But international specialization was reduced. In truth, it was adopted precisely for the purpose of insulating the economy from external as well as internal disturbing influences. Its aim, therefore, was the "selection" of trade and not international specialization.

The premia and surcharges introduced in 1933 and simplified in 1936 proved that even dictators are not masters over the exchanges. In the long run, as we shall presently see, the value of the pengo responded to underlying money and production variables at home and abroad. The gap between the nominal and real foreign value of the pengo was the result of unavoidable economic forces which had to be reduced if the artificial stimulus to imports and the penalty upon exports was to be removed. Still, Professor Ellis' conclusion that "informed observers seem... to ascribe the improvements in both volume and favorable balance of Hungarian trade in 1933 and 1936 to the changes in exchange control" is unwarranted.[51] The other things <u>not</u> being equal were by far the more important factors.

It is difficult to agree with Professor Ellis that Hungary's external difficulties were no less real for Austria, where exchange control was slowly reduced to a control over

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[51] Ellis, <u>op.cit.</u>, p.118.

capital repayments and to clearing with exchange control countries."[52] There hardly seems ground for comparison. Hungary was a small agricultural country, dependent upon her export surplus. The clogged international market forced her to accept the philosophy of étatisme or stifle. Austria, on the other hand, remained a bulwark against German expansion. This may partially explain why Hungary received no foreign loans while Austria did. Neither could Hungary conclude standstills "with the British and American short-term creditors."[53] Austria, furthermore, was a relatively industrial country. The divergent policies in the two countries can probably be traced to the relative strength of these competing groups. In the case of Hungary, the lucrative windfalls went to industry. The higher camouflaged money prices paid to agriculture at the expense of the quiescent consumer precluded a coherent and articulate attack on exchange control. Industry held a favored position under the shelter afforded by the limited devisen allocation for imports. The controls in Austria, on the other hand, hit the industrial exporter most. It is, therefore, not very difficult to understand why the Chamber of Commerce even recommended deflation to restore the parity of the

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[52] Ellis, op.cit., p.149.

[53] "Tenth Quarterly Report on the Financial Position of Austria," p.2. Although Hungary also suspended payments, the "standstill" agreement "between American and British creditors and Hungarian debtors was (only) renewed after long negotiations, for six months beginning on August the 1st, 1932." "Fifth Quarterly Report on Hungary," p.8.

schilling. Even had the authorities wished to retain exchange control in Austria, the technique would have crumbled under the powerful pressure of evasion.

If the Austrian exchange control system was rampant with evasion, the Hungarian administration was just a little better. The latter was subject to legal and illegal circumvention. Smuggling by various technicalities, juggling of bloc pengo accounts to apply the funds to prohibited uses, false bills of lading, manipulation of invoice prices and outright security contraband were commonplace. Evasion through illusory bills of lading was ubiquitous and particularly interfered with bilateral clearings. A decline in the actual pengo rate, instead of stimulating exports and improving Hungary's balance of trade, increased the motive for importers and exporters to overvalue and undervalue invoice prices, respectively. The result was a monotonic depletion in Hungary's devisen reserves. Hungarian exchange control was peculiarly subject to evasion through the repatriation of Bonds and securities. The authorities prohibited but did not succeed in suppressing the private acquisition of domestic and international securities from foreign holders. This technique, as we shall see, was diametrically opposed to Germany's system where repatriation was managed by the Golddiskontbank and the windfalls utilized as export subsidies. The first enactment in Hungary to minimize these lucrative profits was passed in October, 1932. Prior to this date business flourished upon the enormous differentials between domestic and foreign quotations. Security prices in Hungary were often from 66% to 75% higher than they were on the continent.[54] Funds for these purchases were obtained

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[54] Kemény, "Oesterreichischer Volkswirt," Dec.24,1932.
Ellis, op.cit., p.145.

abroad by illegal evasions, e.g. smuggling of currencies, leaving the proceeds of exports on deposit abroad, concealing ownership of foreign balances, juggling parent and subsidiary accounts and depositing tourist expenditures in Austria abroad.

Hungarian corporations bought up their own securities at bargain rates, despite high prices for "bootlegged" foreign currencies and exorbitant payments for the professional services of smugglers. On several occasions payment was made in newly issued bonds, but frequently the corporation simply pocketed the proceeds as profits. Loans from the commercial banks covered the shrinkage of capitalization and thereby violated the pith and substance of their own exchange control regulations.

The original Moratorium decree of December 22, 1931, required that matured obligations and coupons should be paid into the Foreign Creditors' Fund.[55] An administrative rule also provided that out-payments should be made into free pengo accounts only when the bonds belonged to Hungarian nationals. Abuse of this ruling by the purchase of bonds belonging to foreigners led to a decree on October 31,1932, that when application was made for redemption into free pengo accounts, the bonds should be deposited for a week to permit the National Bank to establish its ownership. The enforcement of this ruling was ineffective. On February 4, 1935, substantially the same ordinance was repeated, this time complemented with the requirement of central bank permission for each security transaction with

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55 "First Quarterly Report", Appendix 4, p.23.

foreigners.[56] This measure was to a large extent effective, and finally, on January 22, 1936, the importation of Hungarian bonds was categorically prohibited; the proceeds of coupons could be paid to free pengo accounts only if the bonds were deposited with the National Bank.[57] Two years later repatriations virtually ceased.[58] A sporadic recurrence of the practice attended the debt settlement of 1937, and the development of an inland demand for Switzerland foreign bonds. These evasions were quickly suppressed.[59]

The illegal repatriations exercised a strong downward pressure on the foreign value of the pengo, even a "die-hard" doctrinaire of laissez-faire could take no satisfaction from this breakdown of exchange control. The position of the foreign creditor was exploited by the Moratorium, <u>not</u> to <u>public</u>, but to <u>private</u> advantage; and the adverse turn in Hungarian terms of trade entailed the very costs which exchange control was designed to avoid. This continuance of large illegal repatriations through four years of exchange control bespeaks a lack of administrative effectiveness and a sinister yielding to particular vested interests.

The evasion in the form of repatriation was undoubtedly facilitated by the existence of a free market for gold in Budapest. Although the export of precious metals came under the

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56 "Eighth Quarterly Report," p.12.

57 <u>Ibid</u>., p.12.

58 "Twenty-first Quarterly Report," p.9.

59 "Twenty-third Quarterly Report," p.12.

embargo of exchange control, arbitraging operations, known at times to have involved thousands of bonds at a single deal, were made easy through this method. The impression seems to be that the gold market was tolerated as a sort of safety valve[60] for liquidity preferences and demands for a stable asset. To this we can add the profitable business of repatriation. It is interesting to note that the Hungarian commentators[61] characterized the Budapest gold market as "artificial", "narrow", "speculative", "not significant for exports", and, in short, an altogether fallible index of the foreign value of the currency. This is a striking example of the Canadian position today. We must note, nevertheless, that several indices told about the same story. Until the devaluation of the American dollar, "black bourse" quotations indicated approximately the same amount of pengo depreciation as did the price of gold.[62] The security market is said to have followed gold prices rather closely.[63] The prices of pengo notes in Zurich varied inversely

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[60] Tyler, "Quarterly Reports."

[61] Mr.H.S.Bruce, the Adviser of the National Bank, was also of this opinion. cf."First, Second, Third and Fourth Quarterly Reports."

[62] Black bourse quotations for dollars:

Date	Pengo per $1.00 on "Black Bourse"	Premia on $1	Gold on the gold market
Dec.31,1931	8.3-8.5	47	70
Jan.12,1932	7.7	40	47
Mar.30,1932	8.1	42	37
Apr.30,1932	7.8	40	37
July 15,1932	7.7	39	37
Aug.27,1932	7.3	28	26

[63] Tyler, "Quarterly Reports."
See chart, or Statistical Tables, "Quarterly Reports."

to the Budapest gold price with considerable regularity, and the price of "Standstill Pengo" took a course similar to that of pengo notes, although at a lower absolute level. Also, the agios of quotations on free exchange countries announced at the close of 1935 (as a part of the rate unification scheme) coincided with current quotations of gold. Shortly afterwards, the gold market was suppressed,[64] though the virtual devaluation would have rendered its persistence innocuous. The Austrian experience with an overvalued pengo clearly proves that the real foreign value of a currency cannot be ruled by camouflaged official rates. Underlying factors of relative production and money indices, manifesting themselves in purchasing power parity, are still, in the long run, the masters of the exchanges.

Our assumption, also, that exchange control would raise costs and prices is corroborated by the Hungarian experience. Exports brought higher gold prices and imports entailed higher costs.[65] In the case of two or more exchange control countries it is impossible to ascertain on "a priori" grounds how the terms of trade will shift. The volume of trade must also be impirically determined. Although clearings often level downwards, Hungary's experience with Italy and Germany does not conform to this premise. Should the choice lie between clearings and free exchange, there can be no question of the latter's super-

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64 March 25. "Quarterly Reports."

65 League of Nations Report on Exchange Control. Statistical Tables.

iority. Clearing entails the absorption of factors into relatively unproductive uses, the establishment of mushroom industries, the curtailment of choice, the accumulation of uncleared balances and the procreation of bureaucratic control. Applied to international trade, exchange controls, in conjunction with other import-export barriers, reduced both the volume and terms of Hungarian trade.[66] However, when the issue becomes trade under clearings or no trade at all, choice disappears, and what is one man's poison may become another man's meat. Hungary, for example, was enabled to liquidate her foreign debts cheaply and at the same time sustain exports and employment.[67] The decline in money wages, nevertheless, between 1929 and 1935 is appalling. The hourly average wage for factory work in 1929 was 6.4 cents; by 1935 this rate had dropped to 4.9 cents, a decline of 23 percent. The latter reduction was unparalleled by 18 countries which reported to the League of Nations.[68] The cost of living during this period only fell by 20 percent. Real wages for labour therefore declined. Instead of securing something of a compensation for extensive unemployment by a gain in real wages (Schumpeter's

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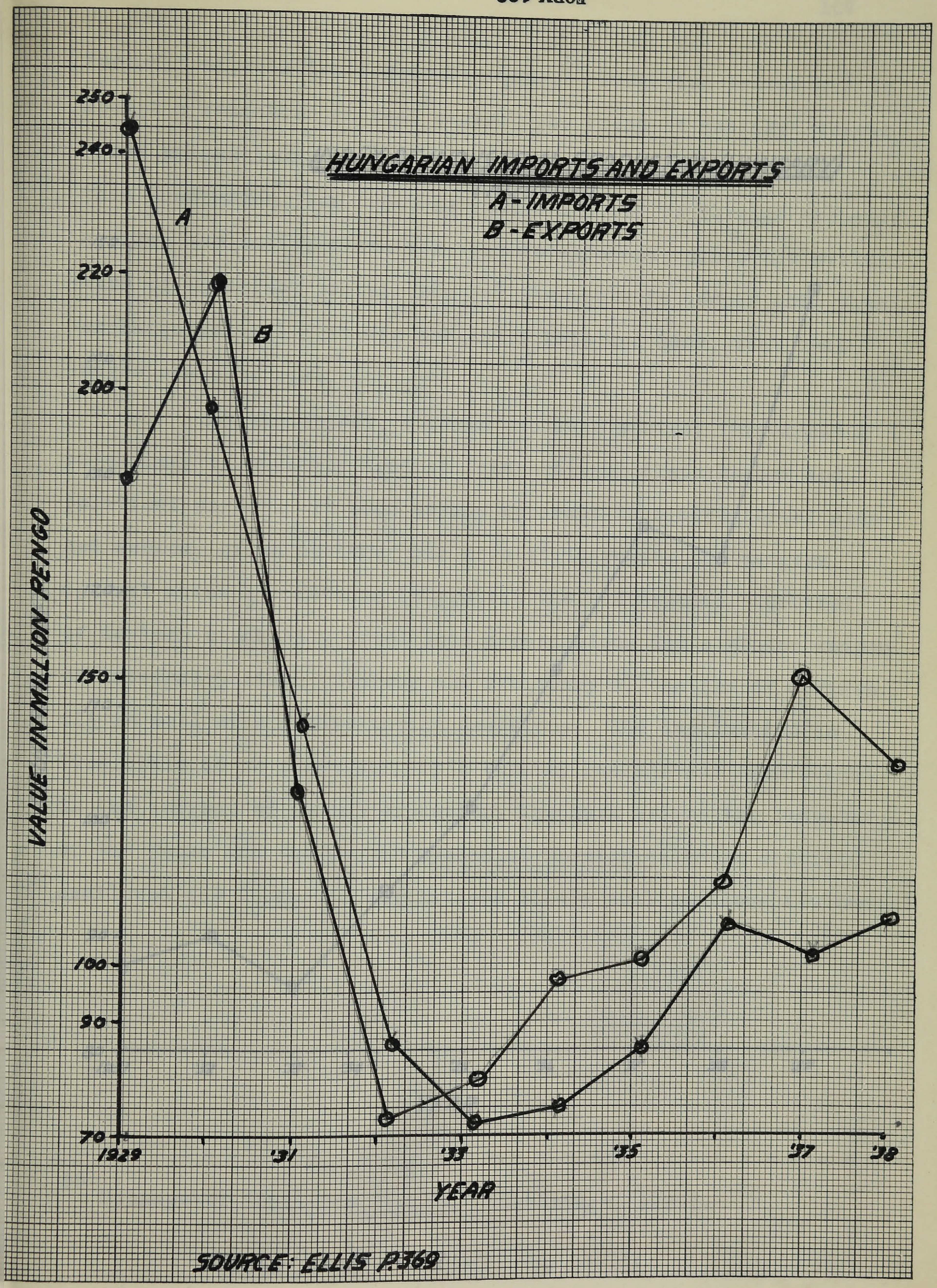
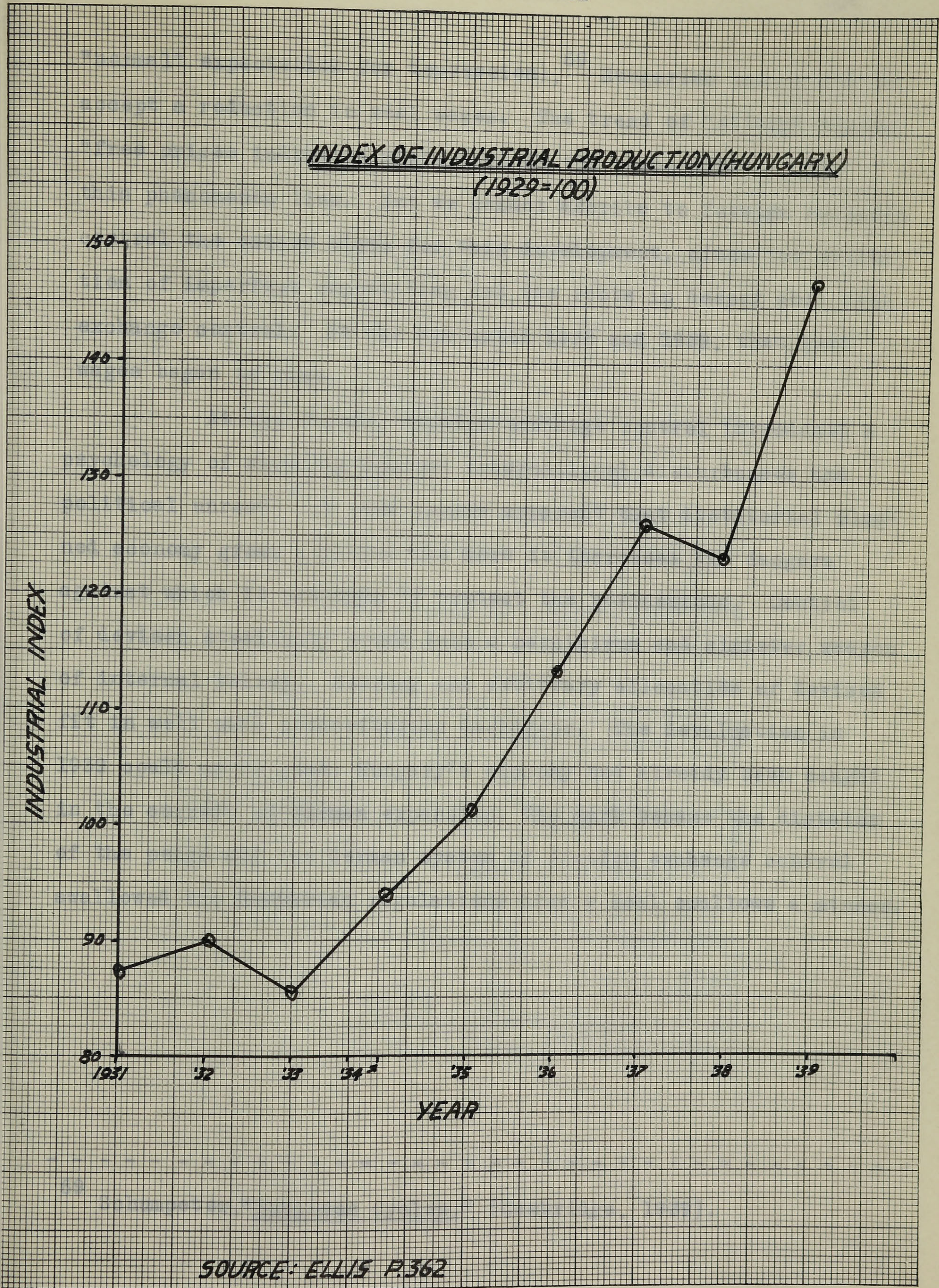
[66] cf.Statistical Tables. cf.Chart No. V also "Quarterly Report", Section II, Trade.

[67] See Chart No. VI Also League of Nations, "Austria's Public Finances.""Second Report."

[68] League of Nations, "<u>World Economic Survey</u>, 1934-35", (Geneva, 1935), pp.136-137; <u>ibid</u>., 1936-1937 (Geneva,1937), p.112.


HUNGARIAN IMPORTS AND EXPORTS
A - IMPORTS
B - EXPORTS
A
B
VALUE IN MILLION PENGO
250
240
220
200
150
100
90
70
1929
'31
'33
'35
'37
'38
YEAR
SOURCE: ELLIS P. 369

No. VI


INDEX OF INDUSTRIAL PRODUCTION (HUNGARY)
(1929=100)
INDUSTRIAL INDEX
150
140
130
120
110
100
90
80
1931
'32
'33
'34
'35
'36
'37
'38
'39
YEAR
SOURCE: ELLIS P.362

"normal" expectation for depression),[69] Hungarian labour had to accept a reduction in real wages. The trend of "sticky" versus "free prices indicates where part of the responsibility for this phenomenon lies. But we cannot ascribe to foreign exchange control the entire blame for this development, since the evolution of imperfect competition had its roots in deeper soil than exchange control. It was not until 1938 and 1939, that real wages began to rise.

At the outset, foreign exchange control introduced a psychology of security against international disturbances and political unrest. It soon became apparent that dictatorial planned economy grows stronger the more it increases the dangers against which it pretends to protect the businessman. Control of devisen stealthily wound into a pernicious and sinister weapon of internal policy. Secrecy and arbitrary allocation of devisen fit in well with authoritarian decisions. The devaluation in 1939 could do no good: Hungary's economy had already been caught in the current of German expansion. The mark became the dictator of the pengo and the German system of foreign exchange control swallowed the Hungarian regulations like a seal swallows a minnow.

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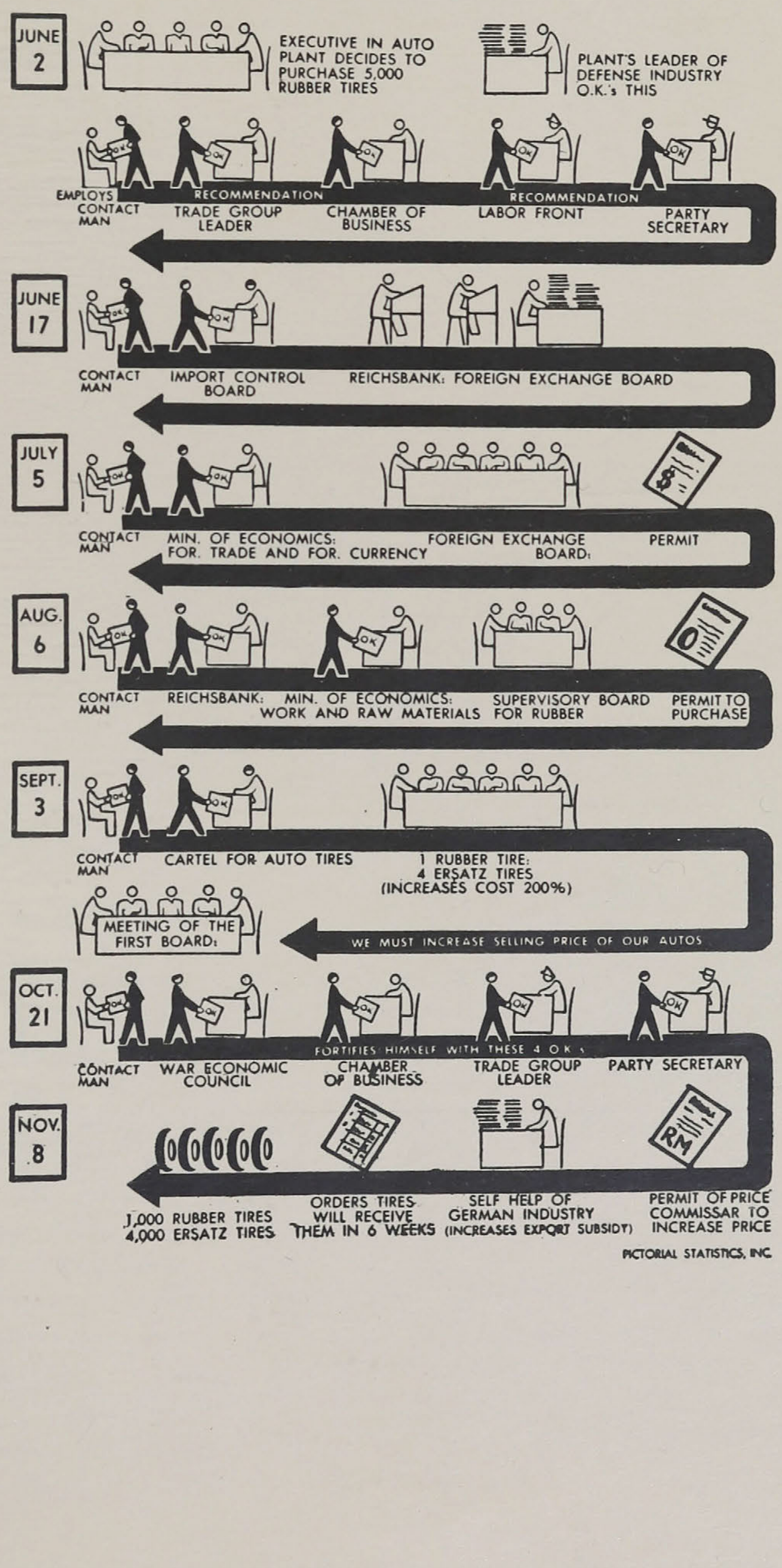
[69] Schumpeter,"Business Cycles," (Cambridge, 1939).

WHAT A GERMAN AUTO MANUFACTURER HAS TO DO TO GET 5,000 TIRES FOR HIS CARS



GERMAN FOREIGN EXCHANGE CONTROL.

(1931-1940)

German philosophy in the nineteenth century is dominated by the ideal of the spirit;(1) German history in the twentieth century is dominated by the omnipotence of the state. National Socialism is the consummation of both these movements. Fascism hurried along with a minimum of intellectual freight having a Termite State before its eyes.(2) "Tout pour le peuple" a été remplacé par "Tout pour la puissance de l'Etat allemand."(3) Political and economic ideologies are closely intertwined. And we must cease in our supercilious aloofness to ignore the fact that the ideas which shaped the world between 1931-1940 were decidedly anti-capitalistic and opposed to nine-tenths of traditional economic thinking.(4)

In the course of fifteen years three catastrophes befell Germany. The first, the military catastrophe in 1918 which culminated in the Treaty of Versailles, made

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1. cf. Hegel, Fichte, Shelling, Schleiermacher and Neitche are only a few of the exponents of German idealism.
2. Wilhelm Röpke, "Fascist Economics", Economica, N.S. Vol. 2, 1935, pp. 85.
3. Piatier, Le control des Devises dans l'economie du IIIe Reich, (Paris, 1937) pp. 144.
4. As early as 1883 the economist Kleinwachter approved cartels as the "pioneer foundation of a state controlled economy." Stolper, German Economy, 1870-1940, (N.Y. 1940); pp. 84. Prof. Lombart in his pamphlet "Händler und Helden" emphasised the contrast between Anglo-Saxon and German economic thought. Even in the German liberal era (1870-90) the profit motive (which is basic to liberal capitalism) was neither regarded as honorable nor desirable by the ruling classes. Ibid. pp. 84.

possible the establishment of the Republic.[5] From the second, the utter collapse of the currency in 1923,[6] the young Republic seemingly recovered miraculously, but in reality the social and political repercussions of the inflation, lay at the roots of further difficulties.[7] The third and final catastrophe, the crisis of the early 30's, resulted in the downfall of the Republic and the introduction of what Müller calls today "modern money".[8] For the moment we can forget the fancy name.

Exchange control, as a system,[9] came to bloom (or wither) in the financial chaos of 1931 and it can never be divorced from the impress of its genesis. German apologists may argue that the system is a "tour de force" of their planned economy but it is important to note that the National Socialists inhereted it from the Social Democrat supported Coalition governments after nearly two years of elaboration.

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5. Shotwell, What Germany Forgot, N.Y. 1940. The author points out that Germany's post-war difficulties are not so much the result of the Peace Treaty itself but the repercussions of the exigencies of war finance practised prior to the debacle. "Nazi Germanism fed upon the discontent which was concentrated upon the Treaty of Versailles, but its origins lay in the wartime mobilization of Germany's strength for war purposes in 1917." pp. 38.
6. It is interesting to note that Hitler's first "Putsch" took place in that year. American immigration laws are to say the least chronologically related to the coming of Fascism to Italy.
7. Theodore Abel, Why Hitler Came Into Power, (N.Y. 1938). The majority of cases studied mentioned the inflation as an important factor in enabling Hitler to come to power.
8. Carl Hermann Müller, Grundriss der Devisenbewirtschaftung, 2nd ed. Berlin (1938) pp. 33, quoted by Ellis, op.cit. pp. 158.
9. Germany did not abrogate her exchange controls after the World War until 1927. They were, nevertheless, in the nature of a reconstruction technique to be dispensed with as soon as possible.

From the middle of July 1931 till November of that year exchange control was an indispensable technique to check the flight of capital. Six decrees on July 15, 16, and 18 put control into operation before the First Devisen Law of August 1st, 1931, was passed. As Piatier points out, "En France, la loi est une décision exécutoire, en Allemagne, au contraire, la loi ne décide rien; elle ouvre une possibilité. Le pouvoir de décision apportien en fait aux diverses ordonnances d'application et aux décisions administratives."(10) These initial decrees(11) gave the Reichsbank a monopoly in foreign exchange, prohibited all but the official exchange rates, and abolished forward transactions in devisen. Owners of foreign claims and means of payment in foreign currencies exceeding 20,000 RM were required to sell them to the central bank. The purchase of devisen with German Securities was not forbidden. It also remained permissible to exchange devisen against devisen. Although the export of Marks through the mails was prohibited by the postal authorities, this was only by implication that the decrees had a general embargo upon the exportation of German money. Residents of Germany who held an equity in excess of 50 per cent of the entire equities in a foreign enterprise consisting of not more than five owners were obliged to declare this fact to the control authorities.

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10. Piatier, op.cit., pp. 48, 49.
11. 1931:1 Reichsgesetzblatt, pp. 365, 366-368, 369, 373-376, quoted by Ellis, op.cit., pp. 166.

These were the initial measures adopted to check the flight from taxation and simple capital efflux.

Evasions followed. "Chaque jour une situation plus sérieuse applait de nouvelles mesures, chaque disposition, chaque texte suscitait de nouvelles fraudes; chaque fraude entraînait à son tour de nouveaux textes."(12) The German authorities were taught at an early date that exchange control must be thoroughgoing or not at all.

On August 1st, before the first steps were taken to open the German banks, the first and relatively stringent Devisen Law came into force by proclamation.(13) The regulations embraced the control of both capital and current account. Foreign exchange control on the one hand, was to stabilize the exchanges; on the other, equilibrate the balance of payments. The task was not easy. Although control of the exchanges is a technique in a secular trend whereby the State extends its power from the internal to the international sphere, the enactment itself sprang from a deep crisis in confidence. The year was one of political unrest. Germany had been demoralized by the devastating experiences of war, revolution, post-war inflation and the Versailles system of reparations. But the crisis itself could not have assumed so devastating a character, had it not been for the precarious situation of German foreign indebtedness and the capital efflux which it permitted.

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12. Piatier, op.cit.,pp. 31.
13. 1931:1 Reichsgesetzblatt, pp. 421-425. Ellis pp. 167.

Capital Movements into Germany.[14]
In million RM.

1924 - 1929				
Year	Long Term	Short Term	Unclas-sified	Balance on Current a/c.
1924	1,000	1,500	400	2,900
25	1,110	300	1,700	3,100
26	1,400	100	900	600
27	1,700	1,800	400	3,900
28	1,700	1,400	1,200	4,300
29	600	1,100	1,000	2,700
Total	9,100	6,200	2,900	18,200

It is not easy to account for the large inflow of short-term capital beginning in 1927. A part is probably ascribable to the increase of German imports by four million Marks between 1926 and 1927. But by far the more important factor was the myopia of American lenders who, to secure the relatively exorbitant interest rates were willing to bear or were ignorant of, the possible consequences which the German practice of investing short-term funds in fixed capital equipment might produce. Further, although from a long point of view capital movement is the cause, and the position of the trade balance the effect,[15] during this short interval, there is perhaps a modicum of truth in the argument that since the United States refused to receive goods as interest and amortisation payments, she had no choice but to invest the

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14. Economist, London. Reparations and War Debts Supplement.
15. B. Ohlin. Interregional and International Trade, (Cambridge 1933); pp. 445. cf. Viner, Studies in International Trade, (N.Y 1937); pp. 310, 311.

money abroad.[16]

Total German foreign debts in mid-1930 amounted to 26,800,000,000 RM; this was divided into 10,800,000,000 RM on long-term and 16,000,000,000 RM on short-term.[17] Capital withdrawals and capital flight in 1930-31 absorbed three billion RM, only 100,000,000 going from long-term. The short-term debt was therefore 13,100,000,000 RM. Acceptances represented only 23 per cent of this debt and even these were invested in such a way as to render the supposed self-liquidating character of these credits illusory. German short-term borrowings were de facto "frozen" long before the inauguration of exchange control and the actual legislation merely placed a rubber stamp on an established fact.

It may be imagined that exchange control was readily accepted by the German authorities. Nothing is farther from the truth. The entire idea was looked upon askance by many. The cumbersome system of permits, difficulties arising from political abuse, a black bourse, or even the collapse of the currency

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16. Ohlin, op.cit. "Behind this view lurks the quasi-merchantilist idea that if a country has a deficit in the balance of trade, and at the same time borrows abroad, the deficit is due to <u>other</u> circumstances than the borrowings and that the latter <u>are</u> necessary in order to equal the balance of payments." pp. 45. Germany's reparation problem, although in no way offsetting the truth of this argument, did introduce "other circumstances" which, lacking statistical evidence, seemed to necessitate capital imports if the balance of payments were to be continued and industry rationalized. "From 1927 to 1929 (first quarter) Germany's balance of trade was unfavourable <u>largely</u> because of indirect effects of loans from the United States." Kenyon E. Poole, <u>German Financial Policies 1932-39.</u> (Cambridge 1940) pp. 23. Again we note the limited truth of the proposed argument.
17. League of Nations, <u>Balance of Payment 1937</u> (Geneva 1938)pp.109

were attributed to its possible existence.[18] L. Albert Hahn, a popular economist in Germany advised the Reichsbank to raise the rediscount rate 30 per cent instead.[19] Neither was his advice overlooked. On August 1st, 1931, the bank rate was raised to 15 per cent; on the 12th it was lowered to 10 per cent and the 8 per cent rate established on September 2nd, remained until December 1931.[20]

After the British devaluation Germany could not compete on foreign markets. In truth, the gold indices of her wholesale prices lagged behind the fall in other countries since 1929; in 1931, they lost all contact with the world price system.[21] The Brüning government still clung to the policy of deflation. Trade unions bitterly opposed the regime from one side, and enterprise from the other. Both labor and industry suffered from the dampening effect of a stringent money market. By the Emergency Decree of December 8th, 1931,[22] Dr. Brüning set the deflationary spiral rolling to an even lower ebb. The cuts in wages and prices were the acts of officialdom and took no account of the structure of production or elasticities of demand of different industries. As the following table shows, money wages dropped but real wages did not since prices fell to a

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18. Ellis, op.cit. pp. 172.
19. Ibid. pp. 172.
20. London Economist.
21. Statistisches Jahrbuch.
22. Kenyon W. Poole, op.cit., pp.22.

greater extent.

Wage and Price Changes.[23]
1928 = 100

Year	Tariff Wage Rates	Wholesale Prices of Finished Industrial Commodities	Relation of Wages to Prices
1930	107	95	113
1932	90	74	122

The drop in wage rates was 15.8 per cent, the drop in wholesale prices 22.1 per cent. Every reduction in wages, coupled with the increased unemployment[24] led to a curtailment in the effective demand. The process was contagious and perculated through the entire economy. Mr. Keynes' thesis that (apart from possible effects on the rate of interest and this qualification seems tenuous[25]) reductions in money wages are not likely to result in reductions in real wages, or in lower wage costs relative to the value of output seems vindicated by the German experience.[26] In his own words, "For although a reduction in the existing money-wage would lead to a withdrawal of labor, it does not follow that a fall in the value of the existing money-wage in terms of wage-goods

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23. Jahrbuch 1933.
24. Unemployment increased from 3,076,000 in 1930 to 5,575,000 in 1932. National income dropped from 70.2 billion RM to 45.2 billion RM. Industrial production from 87 to 58 million RM. Source Jahrbuch.
25. Prof. Schumpeter is of this opinion.
26. J.M. Keynes. The General Theory of Employment, Interest and Money, (London 1938); chapters 15 & 21. Cf. Guillebaud, The Economic Recovery of Germany 1933-38, (London 1940); pp. 22 et seq.

would do so, if it were due to a rise in the price of the latter."[27] Hence follows Mr. Keynes' famous definition which is based on the premise that a lowering of money-wage rates, unless proceeded simultaneously and uniformly all along the line, would chiefly alter the relative rates of wages of different labor groups and would not increase the aggregate volume of employment. In truth, he believes that it is more likely to reduce it. Mr. Keynes therefore suggests that "involuntary" unemployment could only be removed if real wages were to be reduced by a rise in the price of wage-goods, money wages remaining the same or rising in less proportion, but not falling.[28] It is important to notice that the Junkers, whose influence was in the ascendancy under Hindenburg, demanded low interest rates in conformity with other deflationary reductions in costs.[29] Dr. Jacob Viner adds the weight of his authority to such consistency in policy once its application is considered feasible. Viner and Keynes both agree, however, that real wages, under such conditions must be reduced. The former does not believe in monetary camouflage; the latter does not believe that a reduction in money-wages can deal with "involuntary" unemployment. The objective is the same, the

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27. Keynes, op.cit., pp. 8.
28. For a criticism of this view, cf. Jacob Viner, "Quarterly Journal of Economics", Vol. 51, 1936-37, pp. 147-167.
29. Jacob Viner, "Balanced Deflation, Inflation, or More Depression", (University of Minnesota, Minneapolis, 1933) Section IV.

technique to obtain it is different. This seems to be the position of two eminent authorities, but Dr. Ellis is hardly justified in stating that the "Keynesian position [(is)] that an impetus to expanding employment can proceed only through the one channel of lower interest rates."(30) To the knowledge of the writer, Mr. Keynes never said anything of the sort. Rejecting "uniformity" in application, the German deflation was a vulnerable policy both on theoretical and on practicable grounds.

Devaluation was also impossible. (1) Currency depreciation was associated with uncontrolled inflation, because of post-war experience. (2) A policy of devaluation was politically impossible and would have led to further domestic and foreign capital flights. (3) The greater proportion of German debt ran in terms of foreign currencies — Devaluation would increase the foreign debt. (4) Devaluation would increase the price in Marks of raw materials. (5) Trade unions insisted upon an index wage system based on stable foreign currencies. The advantages of exchange depreciation as a method of reducing domestic costs to conform with world prices would therefore automatically disappear. It was exactly because prices did not rise relatively to the depreciation of the currency in England, and that she was the first important industrial country to abandon the gold standard

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30. Ellis, op.cit., pp. 176.

that enabled her to reap an advantage over her creditors.(31) Deflation and devaluation being ruled out, exchange control was the only immediate alternative, no matter what the ultimate policy of the government might be. Further, American creditors were anxious to see exchange control tightened.(32) They feared that devaluation would lead to discriminatory treatment of foreign creditors and to exchange dumping, which in turn would provoke defense measures making debts uncollectable. From 1932 onward, the German government was compelled to abandon attempts to restore price and exchange equilibrium through deflationary measures. The overvalued Mark under exchange control became part of the German economy.

General business malaise and unemployment were rife.(33) It was chiefly the export trade which continued in some measure to maintain employment. As the following graph shows, beginning in the second quarter of 1929 Germany's commodity balance of trade turned active. We have seen that 1931 witnessed a capital efflux of over three billion RM. This was offset by an unprecedented <u>active</u> balance of trade amounting to 2,827,000,000 RM.(34) It was therefore not a passive balance of trade which was the cause of the inauguration of exchange

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31. S.E. Harris, <u>Exchange Depreciation</u>, (Cambridge 1936); pp. 62. There was, of course, an immediate deterioration in Germany's power of competition in world markets.
32. "Economist", July 25th, 1931; pp. 160, (also quoted by Ellis, op.cit., pp. 172).
33. Cf."Stat. J. f.d. D.R." 1933.
34. Ibid, 1933, pp. 184. (Her loans to Russia help to explain the favourable balance.)

(i) Cf Chart II p.35 b

control.[35] In truth, the opinion of the League Report notwithstanding, the German system of exchange control avoided all possible connection with commercial policy. Its chief object was to prevent "irregular" capital exports and <u>not</u> to improve the balance of trade.[36]

Germany's position in one respect resembled that of Canada today. Commodity exports largely repaid debts and repatriated securities. Devisen did not trickle in. Importers, hoping to get enough foreign exchange, doubled their demands. As usual, more stringent regulations to husband the current and accumulated[37] devisen were necessary. Exemptions from foreign exchange control were lowered from 3,000 to 1,000 and subsequently to 200 RM.[38] On November 2nd, 1931, the purchase and sale of foreign securities was made subject to special permission of the authorities. This was largely due to the lucrative evasions through German bond and security repatriations. "Les premiers textes sont simples et faciles à tourner. L'administration finit par connaître assez rapidement les moyens de fraude, et au lieu de s'appliquer à continuer une construction rationelle et cohérente, elle s'efforce de supprimer les possibilités d'évasion."[39]

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35. League of Nations, "Report on Exchange Control". pp. 22 et seq
36. Thomas Balogh, "The National Economy of Germany", vol. 48, September 1938, pp. 480. Germany's exports to Europe and South America fell drastically on account of the devaluation. She lost 50 per cent of her export markets in the Balkans; England's exports increased to these countries.
37. Standstill agreements, negotiations at the Lausanne Conference and the banking reorganization largely consolidated her position.
38. 1931: 1 Reichsgesetzblatt, pp. 463, 534; Ellis op.cit., 182.
39. Piatier, op.cit., pp. 113.

The perpetuation of exchange control was "automatique". Blocked accounts and an overvalued Mark inevitably result in lower security values abroad. Even in the absence of other motives for capital flight, this tendency would provoke attempts to send funds abroad and to smuggle securities into Germany. The blocking of outward transfer also created a tendency of interest rates in Germany to decline.(40) This too stimulated the export of capital. Furthermore, exchange control curtails foreign investment in the country applying it. And finally, because the Mark is overvalued, arbitrage in commodities became possible and the demand for foreign devisen exceeded supply at the official rate. A system of rationing became inevitable.

In November 1931 the control authorities allotted to accredited importers 75 per cent of the devisen used by each firm during the base year, (July 1st, 1930 to June 30th, 1931). The quota was reduced to 55 per cent in April and to 50 per cent in May, 1932. This quota remained in force for nearly two years. It prevented the appearance of new import firms, precluded any shifting of the relative output of firms from the base year and afforded the existing importers a sheltered position. As Mr. Roger Aubouin points out, "Lorsque les autorités entreprennent de parer par des mesures administra-

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40. Bank rate was gradually reduced to 5 per cent by April, 1932. London "Economist".

tives à l'épuisement de la réserve de devises et d'or, elles commencent toujours par déclarer qu'il ne s'agit en rien d'entraver les opérations commerciales, mais seulement d'empêcher les sorties 'speculatives' de capitaux .... Mais il ne faut pas long temps pour constater que, comme par hasard, toutes les demandes de devises ont un but commercial."(41)

From the middle of 1932, the Reichsbank began to grant permission to exporters, (on condition that it be proven that the particular export sale was "additional"(42) to purchase bonds at low prices abroad, resell them in Germany at a profit, and use the windfalls to cover the losses of quoting the export good at international competitive prices. Ellis(43) is correct in taking issue with Heuser's position(44) that the foreign bondholder bore the cost of the export subsidies. In truth, there is no casual link between the profits obtained and the exports which they permitted, since these windfalls may very well have been an ordinary accretion to the national income.

In May 1932, Brüning was overthrown and von Papen became prime minister. Deflationary and reflationary

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41. R. Aubouin, "Où mène le controle des changes"; Europe Nouvelle, 13 février 1937.
42. The word "additional" can only mean that the export was impossible without this concession. The differential in bond rates varied between 30 and 50 per cent. Piatier, op.cit., pp. 137. Some 7,081,000,000 RM in bonds were repatriated between November 1931 to 1933; ibid. pp.138. (From less than 2 per cent in 1932 "additional" exports increased to 14 per cent of total exports in 1933.).
43. Ellis, op.cit., pp. 185.
44. Heuser, "The German Method of Combined Debt-Liquidation ..." Review of Economic Studies, Vol. 1, pp. 210-217.

measures were commingled with one another and the scene was sown for a revival. In December the von Schleicher government carried the New Deal policies further. Gereke initiated the Urgency or Sofort Program entailing 500,000,000 RM. History has shown again and again that revolutions usually take place during a revival and not during a depression.(45) Hitler's coming to power is no exception to that rule.(46) The upswing had begun and he greatly increased the drive toward full employment through public works and credit expansion.(47)

Cost and price equilibrium were sacrificed for "autarchic" policy. That is, not an absolute self-sufficiency unit within the German borders, but the creation of a self-sufficient "bloc" dominated by the needs and aims of the German economy as conceived by its rulers.(48) Such national autonomous action could only mean one thing: the perpetuation of price and cost disequilibrium with "free" currencies, and the intensification of exchange control. "Enfin le contrôle des devises se présente comme une des pièces essentielles du mécanisme de l'économie dirigée nationale socialiste. Réglant, contrôlant et limitant les

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45. The French Revolution of 1848 is a striking example.
46. January 30th, 1933.
47. Cf. C.W. Guillebaud, op.cit., pp. 34-43.
    Cf. Kenyon W. Poole, op.cit., pp. 66-73.
48. A.G. Fisher, "Economic Journal", Vol. 49, March 1938; pp. 177 et seq.

les relations du pays avec l'extérieur, il est l'arme indispensable pour la <u>nation</u> qui, sous le motif d'indépendence économique, tend à développer son autarchie. Il permet une mobilisation économique plus parfaite, en adaptant exactment les importations aux besoins en matières premières et en limitant les exportations aux produits surabondants."[49] The success or failure of German foreign exchange control from 1933 onwards can therefore only be analysed relative to the success or failure of her planned economy and the part that the control played in it.[50] The technique was more a function of internal planning than that of international trade.

Once a "New Deal Policy" is inaugurated, in no way commensurate with the expansion of trading countries, the "automaticity" of price and exchange equilibrium comes into desuetude. Hence, the Mark became more and more overvalued under the camouflaged official rate. This added fire to the flames of evasion and necessitated a still more strict control. The overvaluation also created an inevitable penalty upon exports and an encouragement to imports. The balance of trade inevitably became less active and in 1934 turned

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49. Piatier, op.cit., pp. 8.
50. The system, as we shall see, had deleterious consequences upon world trade and reduced, in the aggregate, German trade, but once we accept the premise that exchange control was an <u>essential</u> spoke in German "autarchy" the criterion of its success or failure becomes the success or failure of the plan as a whole.

passive.[51] This led to the imposition of clearings, either by the control country in self-defense or by the creditor partner for the security of debt.

Given the overvalued Mark and England's competitive advantage in world markets, Germany's foreign trade would have shrunk to a negligible quantity, had not concealed devaluations been introduced and extended. These measures required tremendous additions to the control apparatus. Export stimulation wrought an elaborate government cost accounting system. Costs and prices were gradually checked and later controlled by the State. To become the fulcrum of the gradually emerging "aktive Konjunkturpolitik",[52] exchange control had piecemeal to be reconstructed. But just as the turn fram deflation to credit expansion required the nine months covered by the Papen and Schleicher governments, so the subjugation of foreign trade to economic policy could not be compassed immediately. Remnants of the liberal system could still be discerned, though with increasing difficulty, as late as the summer of 1934.

June 9th, 1933, witnessed the creation of a Conversion Office which proclaimed a transfer moratorium for long- and medium-term debts. The service on these debts was to be paid into the Conversion Office, exception being made for the

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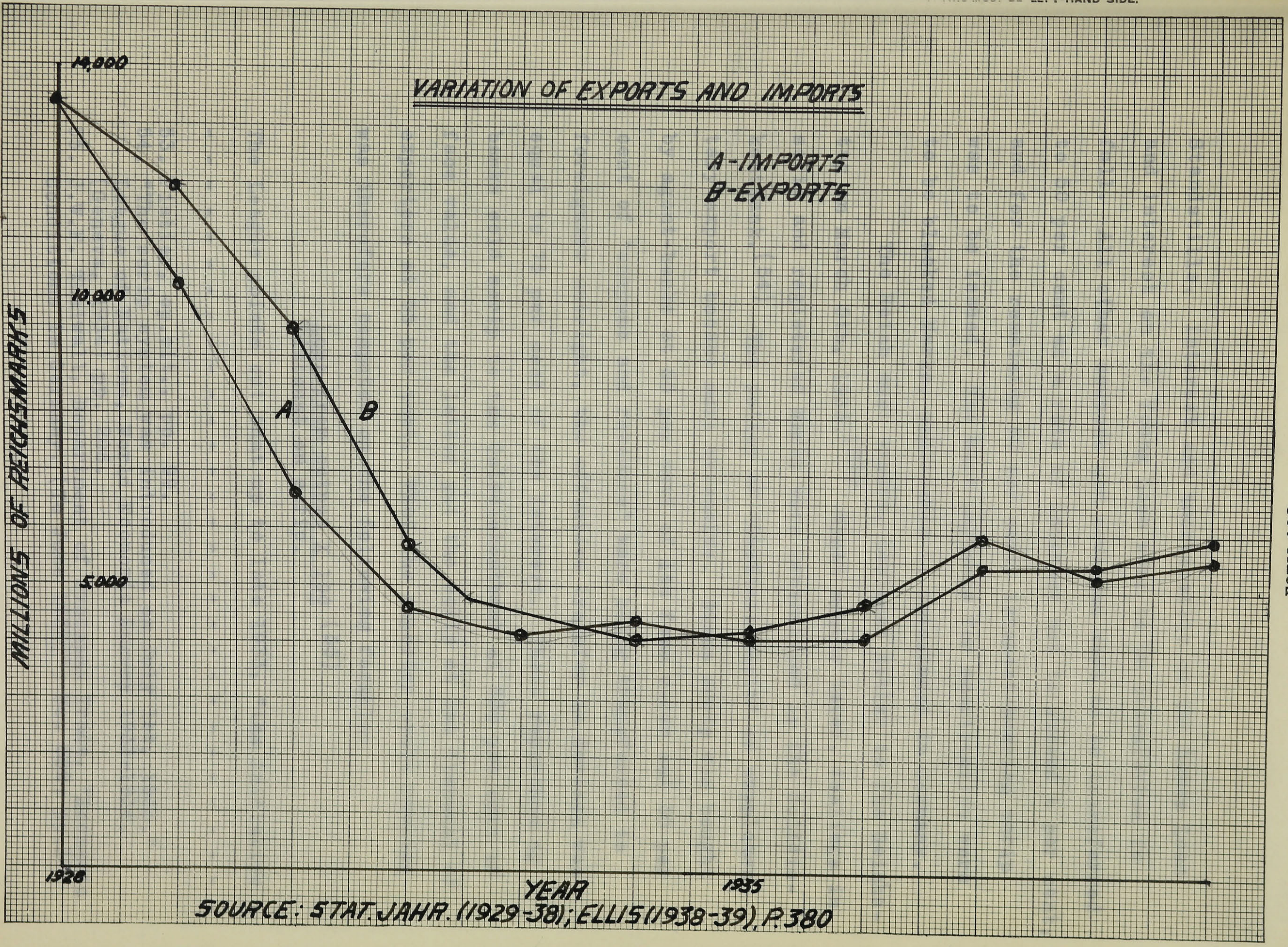
51. Stat. Jahr. 1935, pp. 489; 1937, pp. 536. Chart No 7
52. Active economic policy based on opportunism.


VARIATION OF EXPORTS AND IMPORTS
A-IMPORTS
B-EXPORTS
A
B
14,000
10,000
5,000
MILLIONS OF REICHSMARKS
1928
1935
YEAR
SOURCE: STAT. JAHR. (1929-38); ELLIS (1938-39), P. 380

Standstills. Interest and amortization on the Dawes Loan and interest on the Young Loan were to be transferred in full. All other coupons and revenues were to be transferred to 50 per cent at a rate of interest not to exceed 4 per cent, and for the remaining 50 per cent, interest-bearing scrip was to be issued. The Mark payments for amortization were to be blocked Marks, applicable to investment in Germany.

The Reich must export, declared Hitler to the Reichstag on March 5th, 1933.(53) Eight months later, dealings in scrip and registered Marks were centralized in the Golddiskontbank.(54) The policy of "Zusätzlichkeit" or supplementary export became more extensive. Since scrip was bought by agent-banks at 50 per cent of its face value and 50 per cent of "coupons and revenues" were being transferred to foreigners outright, the effective transfer in devisen was equal to 75 per cent of the interest. These repurchasing banks sold scrip to the Golddiskontbank at 52½ per cent of face value, and the latter put the scrip at the disposal of exporters at 55 per cent. What the exporter could realize was therefore computed on the following formula:

$$\frac{\text{Loss from output X 100}}{\text{Discount on scrip.}}\ ^{(55)}$$

The League points out that up to late 1933, "the initiative

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53. Piatier, op.cit., pp. 99.
54. "The scrip system was introduced on July 1st, 1933." League of Nations, World Economic Survey 1933-1934. (Geneva, 1934) pp. 206.
55. J.W.F. Thelwall, Department of Overseas Trade, "Economic Conditions in Germany. (To June 1934)"; No. 582; pp.37.

in its application was left to the creditors who had received scrip in exchange for part of the interest service due to them. If they could make an arrangement by which some German exporter was enabled to secure 'additional'(56) exports, the exporter after producing detailed evidence that the transaction could not otherwise be carried through, was granted permission by the Reichsbank to use a certain proportion of the foreign exchange received (which otherwise he would have had to convert into RM) at par to buy scrip at a discount, or German bonds at the depreciated foreign price. He then sold the scrip at its face value in blocked Marks or the bonds to the debtor at a premium over their foreign value. The profit made in this way compensated him for the price reduction necessary to conclude the transaction. Strict measures were organised to prevent the system degenerating into uncontrolled price-cutting and dumping, and in practice, it has been estimated that a margin of about 15 per cent of the price was allowed on the average."(57) A Decree (59/33) by the Ministry of National Economy late in 1933,

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56. An export becomes "additional" if
    (a) the prices abroad for similar goods are lower than those in Germany.
    (b) the German exporter cannot be expected to bring down his price. He may only make a small profit or even a loss, but the latter must not be so large that the price does not cover essential wage and material costs.
    (c) the foreigner will only place the order on condition that a certain proportion of blocked or register Marks are used in payment. Thelwall, op.cit., pp. 36.
57. League of Nations, World Economic Survey, (1933-1934); (Geneva 1934); pp. 206. Also Heuser, "The German Method of Combined Debt Liquidation and Export Stimulation"; Review of Economic Studies, June 1934.

transferred the initiative to the Reichsbank. The German exporter from this time onwards was obliged to buy scrip from the Golddiskontbank at a price fixed from time to time by the bank, selling these scrip for blocked Marks to the "Konversionskasse".[58] Piatier claims that "Pour l'année 1933, l'excédent des exportations allemandes s'élevait, à 667 millions de marks et il est possible d'estimer que le systeme d'utilisation des scrips a payé un quart de cette exportation."[59]

The increase in supplementary or "Zusätzlichkeit" exports monotonically increased while the total volume of exports decreased.

Additional and Aggregate Exports.[60]

Year	Additional Exports (1)	Total Exports (2)	Proportion 1 : 2
1932	100,000,000 RM	5,739,000,000 RM	1.7
1933	700,000,000 RM	4,871,000,000 RM	14.4
1934	1,250,000,000 RM	4,167,000,000 RM	30.0

These "additional" exports coupled with Nietzschean pressure politics — "will to export", "export or die" — failed to stem the adverse trend in the balance of trade.[61] The German debt service in free exchange was reduced from

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58. League of Nations, op.cit., pp. 206.
59. Piatier, op.cit. p. 104
60. Thelwall, op.cit., pp. 36. The "additional" exports for 1934 are an estimate. "It is expected that in 1934 they might reach RM 1,250 million."
61. Cf. graph. VII

50 per cent to 30 per cent.[62] Still, in the summer of 1934 the "devisen deficit" mounted to 700,000,000 RM. The quota system of allocating foreign exchange had failed abysmally. Whereas in February 1934 the allotment was 50 per cent of the base year, by May it had fallen to 5 per cent, and finally to a day-to-day allotment, based on the Reichsbank's intake of foreign exchange. Both the importer and the exporter were at the mercy of German officialdom. The overvalued Mark turned ~~her~~ the balance of trade from active (+667 million RM) in 1933 to passive (- 284 million RM) in 1934.[63] Germany was in a veritable dilemma: imports increased without a visible wherewithal for payment,[64] while the industrial upswing[65] required an increase of imported raw materials for its nurture. Furthermore, the entire structure of production was being altered. The government diverted purchasing power from consumers' goods to producers' goods industries. This was done by limiting effective consumption demand and deflecting the expanding volume of money incomes into investment.[66] Above all, a dangerous price

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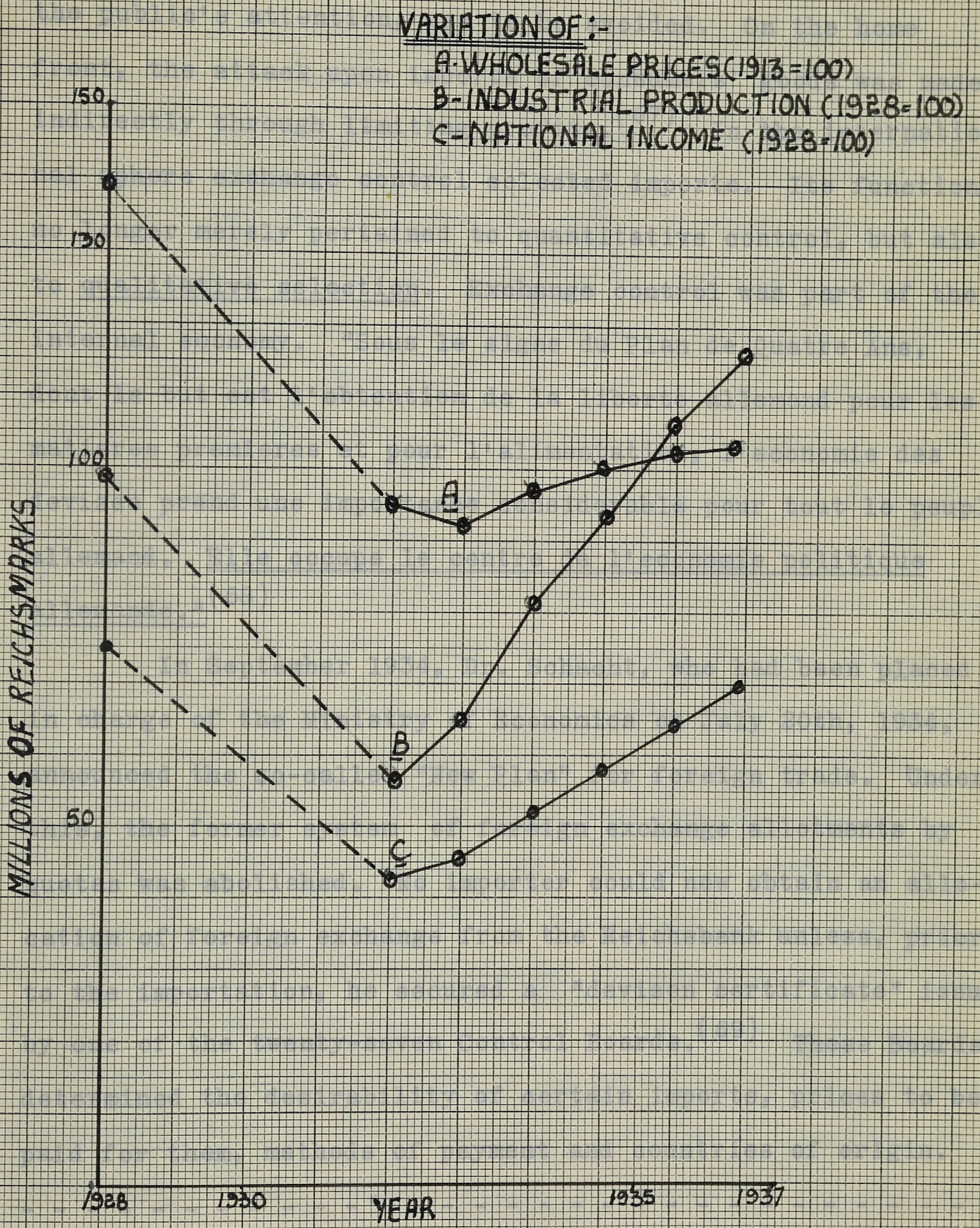
62. December 1933.
63. Cf. chart. No II and VII
64. German clearing debts in 1934 amounted to 450,000,000 RM, L. of N., World Eco. Survey 1934-35 (Geneva 1935); pp. 22.
65. Cf. chart. VIII
66. F. Hayek, Prices and Production, (London 1936) for theoretical aspect of the problem. (a) Balogh, "The National Economy of Germany", Economic Journal, Vol. 48, pp. 461-498. (b) Guillebaud, op.cit., pp. 283. (c) Poole, op.cit., pp. 141 et seq. (d) Fletcher Pratt, "German Planning for Total War", Harper's Magazine, February 1941. (e) Dal Hitchcock, "The German Financial Revolution", Harper's Magazine, February 1941.

No. VIII



SOURCE: STAT. JAHR.

inflation, at least in those segments where it would strike the public's attention, was to be avoided. On the home front, the attack upon imports of consumers' goods was made indirectly through limiting profits.(67) In the international sphere exchange control selected imports. Its function no longer merely pertained to quantitative control, but also to <u>qualitative selection</u>. Exchange control was part of the internal economy. "Sous le signe du Plan de Quatre Ans, dont le but est l'obtention de la liberte allemand pour les matieres premieres et pour l'alimentation, l'economie des devises prend une importance considerable pour tout le peuple allemand. <u>Elle occupe le centre de l'economie politique allemande."</u>(68)

In September 1934, Dr. Schacht, who had been placed in charge of the Ministry of Economics on July 20th, 1934, announced the so-called "New Plan" for foreign trade. Under this, the former system of foreign exchange allotments by quotas was abolished. No importer could now obtain an allocation of foreign exchange from the Reichsbank unless, prior to the importation, he secured a "devisen certificate" issued by one of the twenty-seven Control Boards.(69) These Boards determined the desirability of certain imports, prices to be paid for them, methods of payment and countries of origin.

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67. In April 1934 a decree forbid higher prices upon raw materials.
68. Dr. Hartenstein, 5 janvier 1937; Devisenarchiv; quoted by Piatier, op.cit., pp. 124.
69. By June 24th, 1935, importation without a devisen certificate was prohibited. That is, even if devisen could be obtained elsewhere, imports were disallowed.

They issued four types of devisen certificates according to:

(1) imports involving cash payments and to be used for further fabrication and re-export;

(2) imports financed through acceptance credits which would prospectively be renewable;

(3) imports based on normal commercial credits;

(4) imports on clearing- and payment-agreements.

Further, these Boards examined invoice prices with the greatest of scrutiny. This check minimised capital flight and "inward" contraband through fictitiously low and high invoice prices, respectively.(70) The scheme embraced all payment possibilities with the one exception of "Aski" Marks(71), which could be used without previous application to a Control Board. Although exports were not directly controlled, an embargo was imposed upon certain raw materials. "Additional exports" were still subject to the requirement of ad hoc premiums and there can be no doubt that the indirect drop in aggregate exports was the result of import control.(72)

The embracing extent and objectives of the New Plan bespoke an authoritarian philosophy of exchange control. Imports of finished and half-finished goods were to be reduced; exports of raw materials were to be curtailed and exports of finished goods were to be pushed. The channelization of trade was to become more rigid. Germany wished to reduce her imports from

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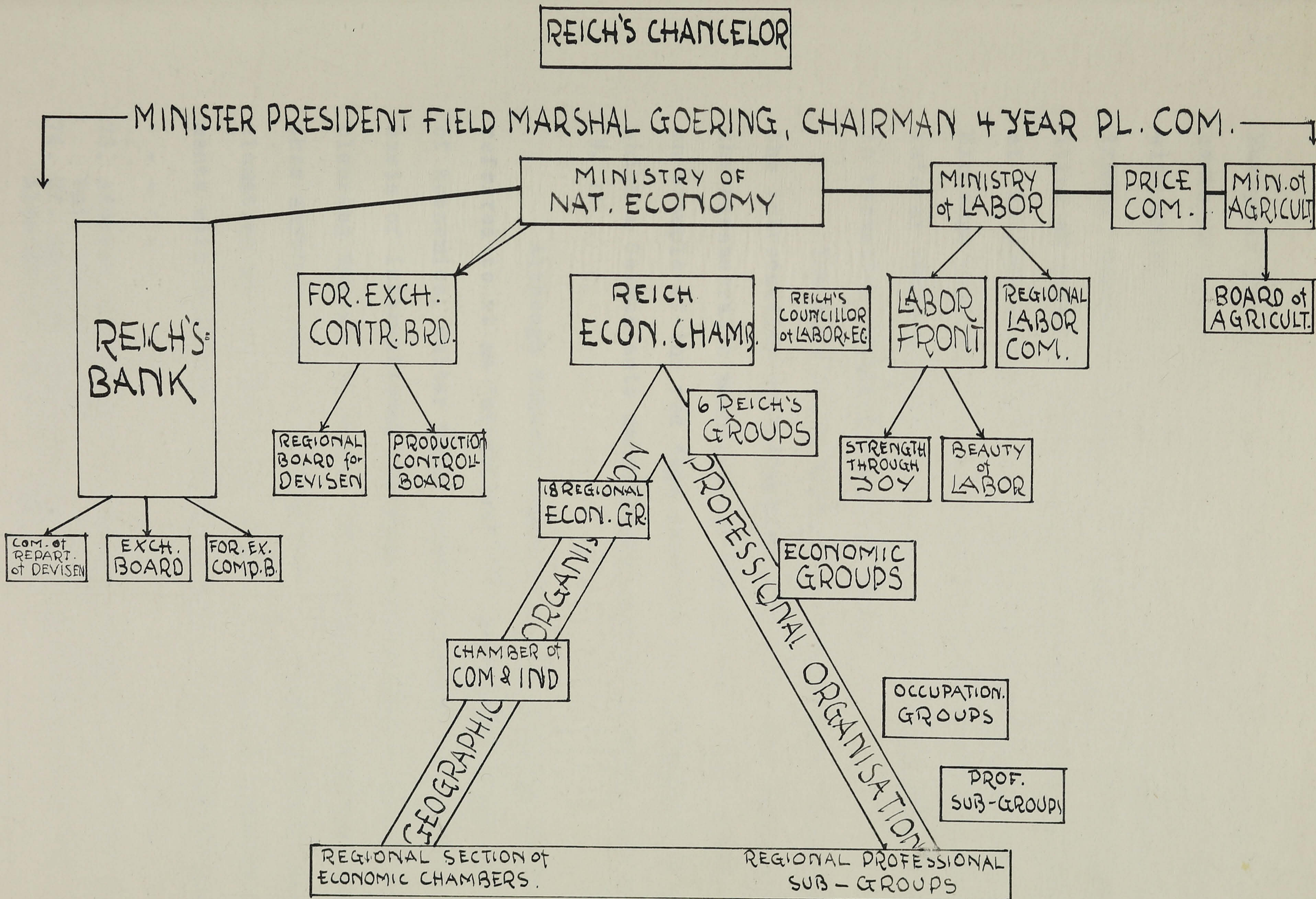
70. For an example of the rapid intercourse between the Reichsbank and its satellite institutions, see Piatier, op.cit., pp. 44.
71. Ausländersonderkonten für Inland.
72. Cf. chart. VII



REICH'S CHANCELOR
MINISTER PRESIDENT FIELD MARSHAL GOERING, CHAIRMAN 4 YEAR PL. COM.
MINISTRY OF NAT. ECONOMY
MINISTRY of LABOR
PRICE COM.
MIN. of AGRICULT.
REICH'S BANK
FOR. EXCH. CONTR. BRD.
REICH ECON. CHAMB.
REICH'S COUNCILLOR of LABOR & EC.
LABOR FRONT
REGIONAL LABOR COM.
BOARD of AGRICULT.
6 REICH'S GROUPS
REGIONAL BOARD for DEVISEN
PRODUCTION CONTROLL BOARD
STRENGTH THROUGH JOY
BEAUTY of LABOR
18 REGIONAL ECON. GR.
COM. of REPART. of DEVISEN
EXCH. BOARD
FOR. EX. COMP. B.
ECONOMIC GROUPS
GEOGRAPHIC ORGANISATION
PROFESSIONAL ORGANISATION
CHAMBER of COM & IND
OCCUPATION. GROUPS
PROF. SUB-GROUPS
REGIONAL SECTION of ECONOMIC CHAMBERS.
REGIONAL PROFESSIONAL SUB-GROUPS

European industrial countries and increase her exports to overseas countries supplying raw materials, i.e. countries with which Germany had always had unfavourable balances of trade. Schacht's "New Plan" meant a change in the composition of trade so as to favour employment within Germany and at the same time force an "autarchic self-sufficient bloc". Exchange control in conjunction with new clearings and bilateral trade proved, as we shall see, a formidable weapon in recasting Germany's foreign trade.

The mere imposition of this "New Plan" necessitated the introduction of a Clearing Office in 1934 which extended the bureaucratic machinery of import and export control. For an example of the red tape involved and the stacks of permits which a German auto manufacturer had to procure, see chart No. ix

Although Schacht deprecated the clearing system and referred to it as "atrocious"(73) four years later the Minister of Economics, Walter Funk, urged the world "to look for the basis of international currency stabilization in a sensible clearing system in which the Germans have had more experience than anybody else in the world."(74) Shortly after the proclamation of the "New Plan" Germany concluded clearing agreements with Argentina, Brazil, Chile, Colombia and Uruguay.

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73. Address of Schacht at Leipzig on March 4th, 1935; Economist, Vol. 120, pp. 526.
74. Cf. Address of Walter Funk, N.Y. Times, March 7th, 1939. Also Ellis, op.cit., pp. 212.

These clearing agreements were an attempt to get out of the impasse into which the independent exchange controls of different countries had led. But the mistake was made of trying to reopen the channels of payment without restoring the mechanism of adjustment which consists in the flexibility of either prices or exchange rates.

The technique employed to circumvent this difficulty is known as the "Aski" device. These blocked Marks are instruments of controlled barter. Each stipulated commodity imported into Germany from a certain country is offset by an ad hoc sellers' account. The foreign exporter can then draw upon this account for German goods of certain categories under specific conditions laid down by the exchange control authorities. It is apparent that if a country is prepared to export only those commodities in which she has the greatest comparative advantage, then obviously the exchange can be maintained at a much higher rate than if the international division of labor is fully utilised.

The overvalued mark led to arbitrage operations in commodities. Evasions followed. And the authorities gradually eliminated the "Aski" technique. The adverse balances on current account of December, 1934, and January, February, 1935(75) clearly show that an overvalued mark is a more potent

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75. See chart. II

import stimulus than Schacht's "export or die" slogans.

In January, 1935, a new form of veiled devaluation was introduced in Germany. It consisted of a more or less general and uniform export premium. This premium averaged 25 per cent of the export value. While under an open devaluation the exporter (or seller of foreign currencies) receives his subsidy from the proceeds of a premium or surtax on the official rate of exchange payable by the importer (or buyer of foreign currencies), under this system the sums required for the payment of export bounties were raised by a special levy imposed on industry as a whole. The necessary check on imports, therefore, was not an automatic one but had to be provided by administrative control and selection of imports through a bureaucratic and comprehensive licensing system.

The last six months in 1935 witnessed an active trend in the balance of trade[76] and the year closed with an export surplus of 111,000,000 RM.[77] This surplus rocketted to 500,000,000 RM in 1936.[78] The <u>absolute</u> decrease in imports in 1935, nevertheless, was three times that of the increase in exports.[79] Germany's active balance with European countries decreased while her passive balance in overseas trade decreased still more. Imports <u>from</u> Europe in 1935 were

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76 . Stat Jahrbuch. Also Chart No II.
77 ibid, 1938
78 ibid., 1938
79. Chart No VII

61.6 per cent of total trade, (the highest since 1929) while exports to European countries fell from 76.5 per cent to 73.2 per cent between 1933 and 1934.(80) This development carried on persistently up to the outbreak of the present war. The old trade system by which Germany paid with exports to Europe for her imports from overseas was breaking down under the pressure of bilateralism. Exchange control played a predominant part in this channelizing of trade.

So far as composition of foreign trade is concerned the "New Plan" was also successful. Exports of raw materials fell from 11.1 per cent to 10.5 per cent; foodstuffs from 3.6 to 2.2 per cent, while exports of finished goods rose from 75.6 per cent to 77.6 per cent.(81) Imports of raw materials increased from 34.6 per cent to 37.7 per cent, while the percentage of finished goods imported to total imports fell from 12.9 per cent to 9.8 per cent.(82) Exchange control in conjunction with other measures, selected imports and stimulated exports as the authorities desired : Foreign trade was subordinated to internal policy.

On the home front business boomed.(83) During the first half of 1935 the Reichsbank increased its purchases of the "special" bills, issued to finance rearmament. This

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80. Statistisches Jahrbuch.
81. Ibid.
82. Ibid.
83. See chart. VIII

resulted in excessive liquidity in the short-loan market. The market rate of interest fell in May 1935 to 2 7/8 per cent and lost touch with the Reichsbank rate which continued to be 4 per cent.(84) The Golddiskontbank was given authority to sell "Solawechsel" (Treasury Bills) to the commercial banks and use the proceeds to buy "employment" and "special" bills from the Reichsbank. In this way the discrepancy between the interest rates was removed and the risks of inflation were counteracted.

The determining factor in issuing new bonds was the growth of the national income and savings available for long-term investment. The issue of new industrial bonds and shares was restricted almost to nothing in order to concentrate the whole of the available savings seeking long-term investment upon the public bond market. With relation to the capital market, savings were accumulated in private hands, and then, for the most part, not invested directly in new issues, but placed with the banks and insurance companies, which in turn invested them in public loans. "The effects of the Dividends Limitation Law of 1934 and of the restrictions on new capital issues were to cause firms to reinvest much of their undistributed profits in their own business."(85)

Through borrowing, taxation, party levies, "Winterhilfe" unemployment contributions, etc. effective purchasing

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84. Economist, London.
85. Guillebaud, op.cit., pp. 87.

power was not permitted to impinge upon the relatively scarce consumer market. The value of the "Mark" is a function of changes in both aggregate supply of money, on the one hand, and changes in individuals' willingness to hold stocks of money on the other. The former could be controlled by the monetary authorities, the latter could not. Exchange controls and rationing therefore, handled the "willingness" to hold stocks of money. Rationing made coupons instead of marks the medium of payment, thereby removing the velocity factor wherever they applied; exchange control precluded the importation of luxuries and many consumers' goods, thereby "rationing" imports and liberating funds for capital investment. Exchange control, therefore, played an important part in securing the desired equilibrium between effective money units and physical units. Inflation was prevented.

The index of industrial production rose from 77.2(86) for the average of 1934 to 99.4 for 1935, and reached 118.8 in 1937. The output of consumption goods lagged behind the expansion of production goods, but also showed a considerable increase. The corresponding figures for consumption goods were 95.6 in 1936, and 101.5 in 1937. The proportional change in output of production and consumption goods was as follows:

	Production Goods	-	Consumption Goods.
1926-1929	100	:	70
1929-1932	100	:	50
1932-1937	100	:	23 (87)

86. See chart. 1928 = 100. VIII
87. Statistisches Jahrbuch.

National income[88] rebounded from 45.2 billion RM in 1932 to 71 billion RM in 1937. Profits of industry and trade nearly doubled between 1933 and 1937.[89] Our "orthodox" assumption that capital formation is a function of a high rate of interest, resulting in savings and therefore investment does not conform to the German experience. Exchange control largely insulated the German economy from foreign capital markets. Savings, gold and devisen reserves reached a low ebb prior to 1932.[90] The rate of interest was gradually reduced thereafter.[91] Still, investment in producers' goods came first, incomes rose, savings increased and more investment followed.[92] This does not warrant a categorical generalization. There is probably some truth in both these arguments. It does show, however, that under different circumstances different lines of causation may ensue.

The output of consumers' goods in 1932 stood at 74 and equaled 13.4 billion RM.[93] In 1937 it was 101.5 and equaled 13.9 billion RM.[94] The population of Germany increased by 3½ millions from 1928 to 1937. It is a liberal estimate to assume that the increase in population absorbed 1 billion RM of this output. The national income in 1928

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88. See chart. VIII
89. 1933 - 6.4 billion RM; 1937 - 12 billion RM. Statistisches Jahrbuch.
90. See chart. I
91. Economist, London.
92. Statistisches Jahrbuch.
93. 1928 = 100. Prices corrected for 1928 price level.
94. Statistisches Jahrbuch.

was swollen by the large volume of imports financed by foreign loans. Prices in 1937, on the other hand, may also inflate the real value of the commodities but probably to a much smaller degree. The conclusion, therefore, is that under a regime of exchange control the standard of living of the population as a whole, as measured by the available supply of industrial consumption goods, was higher in 1937 than it was in 1932. In fact, it had about regained the level of 1928. This was possible because Germany was "willing to bear the heavy economic armor, the pressure of which was felt always and everywhere, and which narrowly hampered free action."(95)

It was only because Germany is a highly industrialized country that she was able to build up a semi-insulated economy and increase production and employment by tremendous strides. The industrial exports, profits upon bond repatriations and foreign devaluations produced a favourable balance of trade. Germany's surplus was sufficient to permit fairly substantial repayments on the short-term foreign debt. By

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95. H. Schumacher, Germany's Present Currency System: Its Development and Its Reform, in A. D. Gayer (ed.), Lessons of Monetary Experience, (N.Y. 1937); pp. 221. According to Herr Funk, Minister of Economics, the export trade involved some 40,000 separate transactions daily, with the unusual case of 40 forms to be filled out for each transaction. Guillebaud, op.cit., pp. 222. Even Schacht referred to these bureaucratic offsprings as "odious things" (etwas scheussliches). The political power which such an administration must command need hardly be discussed.

1933, capital flight was reduced to manageable proportions; evasions had been largely curtailed, and illegal dealings in Marks at black bourse rates were being effectively suppressed. Even Gottfried Haberler regarded the application of exchange control during the first two years as reasonably satisfactory.[96]

The economic structure of most Balkan and Danubian States was radically different. A number of them specialized in the production and export of a few staples, and, in spite of the post-war development of their industrial capacity, they were largely dependent on these exports for the means to pay for imports and for the service of their foreign debt. Owing to this dependence on the export of a few commodities, their economic position was highly vulnerable. They could not readily adopt the device of high internal prices to compensate the producers for low world prices, since the proportion of goods sold on the domestic market was small. Further, no agricultural country can adjust its production to variations in world demand so rapidly as industrial countries are able to do. Thus in a severe depression, the terms of trade move violently against these agricultural states[97]

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96. Gottfried Haberler, <u>The Theory of International Trade,</u> (London 1936); pp. 86.
97. League of Nations "Review of World Trade", Geneva 1938.

	Price Movement in Gold			
	1929	1932	1937	1938
1) Foodstuffs	100	52.0	45.5	43.0
2) Materials, raw or partly manufactured	100	44.0	47.0	42.58
3) Manufactured articles	100	63.5	51.5	50.5

and this tends to exacerbate their economic position. Most Balkan and Danubian States had reached this impasse by 1931. Trade channels were clogged and they were compelled to bind their destinies with larger economic units and accept the relative controls pertaining to them.

It can hardly be questioned that Germany and the Balkans are industrial-agricultural complementary countries. This complementarity is also furthered by geographic proximity. True, economic distances are not always proportional to miles; transportation by rail from Southeastern Europe to Germany is costly, the sea route circuitous and Danube shipping limited in capacity. The trade which loomed between Germany and these countries no doubt had a political as well as an economic foundation.

In 1932, Germany concluded bilateral trading agreements with the six countries of Southeastern Europe[98] with the avowed purpose of providing amortization of her outstanding credits to this region. This policy was successful and in the bilateral trade between 1932-39 exports did not fall to the level of imports. Generally speaking, trade fluctuated in relation to cyclical trends.

The German economy under Hitler was oriented toward a future war. Her gold and devisen reserves were deplete. Trade was hence directed to those countries who did not or could not demand payment in devisen. The monopsonistic pos-

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98. Bulgaria, Greece, Hungary, Jugoslavia, Rumania and Turkey.

ition which she created for herself by conniving "bilateral" agreements led to her having a monopoly in significant segments of her partner's market. In Bulgaria the "bloodless invasion" met with least resistance. She even had a secret agreement with Germany for imports to Bulgaria originating overseas. This indicated the isolating of the economy from world markets and incorporation into the "Axis bloc." Bulgaria paid 25 per cent of her German imports in free foreign devisen for this privilege in 1938.[99]

In the case of Turkey Germany paid 60 per cent over world market levels.[100] And in the Autumn of 1938 she granted Turkey a loan of 12 million pounds sterling to be expended in Germany for industrial military equipment.

Rumania initially resisted Germany's onslaught. She limited petroleum exports to 25 per cent of total exports to that country. When Germany occupied Czechoslovakia Rumania's resistance came to an end. The trade agreement of March 23rd, 1939, subordinated Rumania to the German economy.

Summarily, exchange control, quotas, import restrictions, etc. reduced the <u>Western</u> European share of imports from 23.2 per cent in 1931 to 20.6 per cent in 1932. Schacht's

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99. T. Kalinov, <u>Bulgaria's Trade with Germany,</u> in Stopanski Problemi, Vol. 1, (Oct. 1936); pp. 378. Ellis, op.cit., pp. 261.
100. Economist, May 20th, 1939; pp. 43.

"New Plan" intensified the drive to pay for overseas raw materials by exporting to these countries and reduced the percentage to 16.9 at the end of 1937.(101) The share of exports to Western Europe hovered about 40 per cent from 1931 to 1934. After the inauguration of Schacht's Plan, this share of exports declined to 27.5 per cent by 1938. These clearings forced German trade to more distant markets and the prices of imports and exports were, as expected, higher than those of free countries.(102)

The pressure of bilateralism carried German trade toward South America, the Danubian and Balkan States. The share of German imports from Europe, as compared with the rest of the world(103) declined as follows: 1935 - 61.6%; 1936 - 59.8%; 1937 - 55.6%. On the export side the percentage declined from 81 per cent in 1932 to 69.3 per cent in 1937.(104) Exchange control in conjunction with bilateral clearings was chiefly responsible for the change from 1929, when an export surplus of 2,857,000,000 RM to Europe paid for an import surplus of 2,821,000,000 RM outside Europe, to 1938, when these figures amounted to no more than 698,700 RM and 901,700 RM, respectively. The relative increase in imports now came from Southeastern Europe.

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101. For the entire trend towards bilateralism see V.B. Condliffe, League of Nations, "World Economic Survey, 1934-35", Chapt. VI. Also, <u>The Reconstruction of World Trade,</u> (N.Y. 1940), by the same author.
102. Statistisches Jahrbuch.
103. Ibid.
104. Ibid.

Germany in the Trade of Southeastern Europe.

(I - Imports; E - Exports)

	1929		1931		1934		1937	
	I	E	I	E	I	E	I	E
Bulgaria	22.2	29.9	23.3	29.5	40.6	42.8	54.8	43.1
Greece	9.4	23.2	12.2	14.0	14.7	22.5	27.2	31.0
Hungary	20.0	11.7	24.4	12.7	18.2	22.1	26.2	24.1
Jugoslavia	15.6	8.5	19.3	11.3	13.9	15.4	32.4	21.7
Rumania	24.1	27.6	29.1	11.4	15.5	16.6	28.9	19.2
Turkey	15.3	13.3	21.3	10.7	33.8	3714	42.1	36.5

That these countries were cajoled, bullied, cheated, lured and virtually forced into trade with the Reich is irrevocable. Nevertheless, the "New Plan" and exchange control as part of that plan accomplished the main purpose for which it had been called into being: Germany had formed an "autarchic" bloc prepared for war. Her exchange controls underwent no significant changes even after the war broke out.(105) It is important to remember, however, that the military strength with which Germany has dismayed the world in the last two years is not a vindication of economic strength. The ratio of producers' to consumers' goods in 1937, it will be recalled, was 100 : 23. That situation, no doubt, has even become more adverse in the last five years. Ruthlessly efficient exchange control which has reached its nadir in being perverted to a weapon of autarchic policy can not ameliorate that situation.

Dr. Fritz Meyer lauds "the German exchange control [as] a new monetary system which, of all systems existing at

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105. Economist, London; vol. 138 (May 4th, 1940), pp. 815.

the present, embodies in the purest way the fundamental principle of the classical gold standard, that is to say, the maintenance of a stable exchange rate by adjustment of the domestic price level."(106) Our investigations refute both these premises: camouflaged devaluations do not keep an exchange stable and rationing certainly precludes price adjustment. That exchange control is a "system" we shall all agree. But is it a positive, economic, universal system or merely a discriminatory technique, nipping "profit" for one country or a group of countries at the expense of all ?

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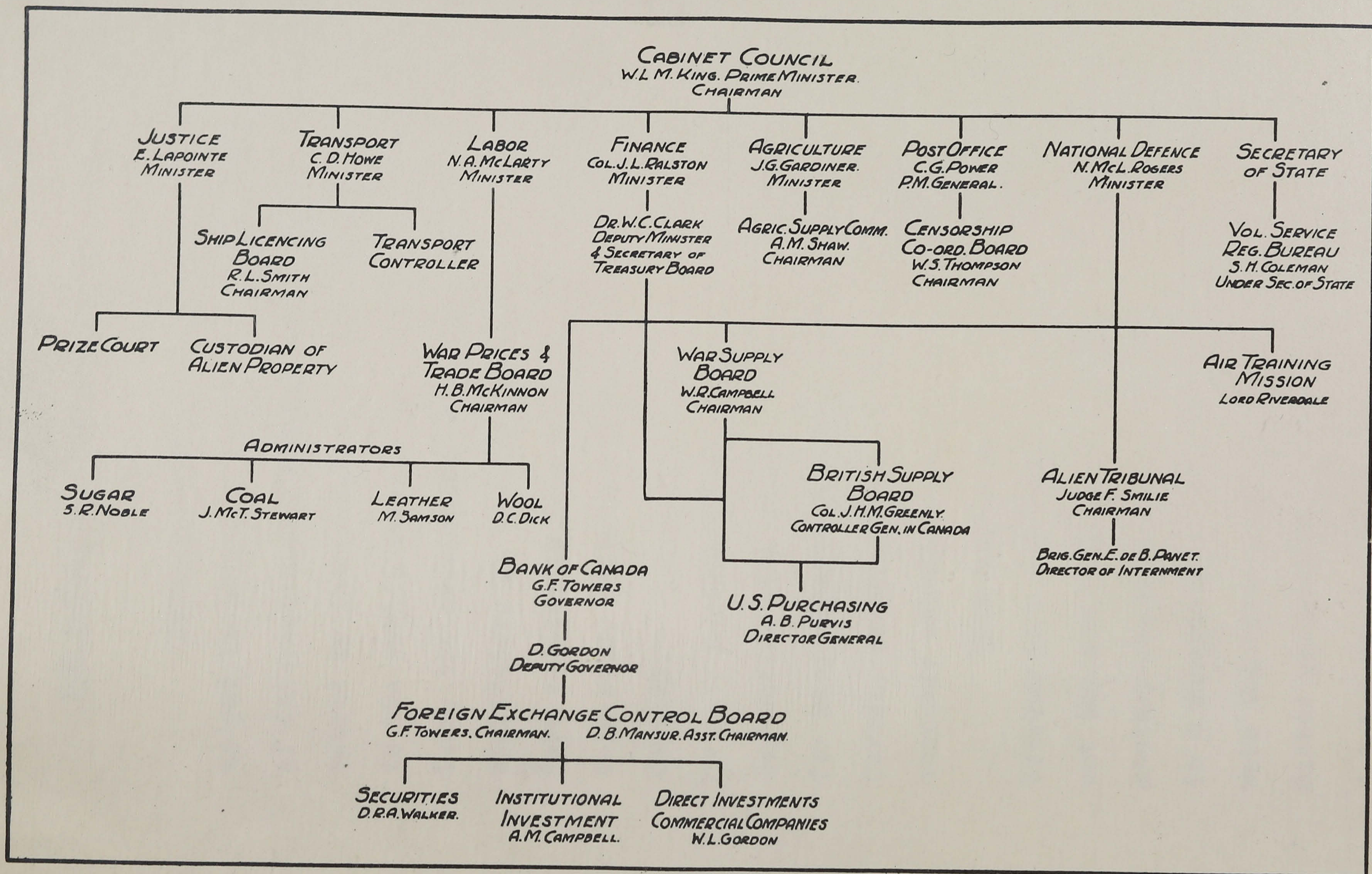
106. Dr. Fritz Meyer, Devisenbewirtschaftung als neue Währungsform; Weltwirtschaftliches Archiv, Vol. 49, No. 3, pp. 465-466; Ellis, op.cit., pp. 232.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SECRETARY OF STATE
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TRADE BOARD
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CHAPTER VIII

CONCLUSION.

THE IMPACT OF EXCHANGE CONTROL ON CANADIAN ECONOMY.

Exchange control in Canada does not lend itself, as yet, to critical analysis. With respect to our balance of international payments, the situation is somewhat obscured by the reticence of the government in disclosing to the public certain very important statistics. Nevertheless, the experiences with exchange control in Europe are applicatory to the Canadian War situation. We are therefore tempted to draw certain concluding inferences from this study which are pertinent to Canadian foreign exchange control.

Because of the nature of its origin, and its close connection with serious economic weakness, devisen control, for many signifies a very sinister meaning. In the case of Canada, exchange control is not an outgrowth of underlying economic maladjustments. It is a sinew of modern war.(1)

This thesis cannot go into the details of how, between 1918 and 1938, the United States and Canada hammered out the compromises between their half rival, half complementary economic sturctures. As might have been expected in a neo-Mercantilist world, the most conspicuous landmarks were the rival tariff walls. Beginning in 1921, the United States proceeded steadily and systematically to protect

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1. G.F. Towers, Sinews of War, An address given on April, 1940.

home industries by building higher and higher tariff barriers against products from abroad which competed with them. While a number of important Canadian products remained on the free list, many others were practically excluded. These measures were not important between 1925 and 1929. The soaring North American boom which halted in 1929 and dissolved in 1930, swept Canada as well as the United States to remarkable economic heights and dropped them both to equally remarkable depths. The tariff issue once more loomed to the fore and reached its peak in the curiously defiant restrictions set up against Canadian copper and certain wood products just before the British nations were convoked to consider economic re-organization of the Empire at Ottawa in the summer of 1932. Great Britain had just adopted protection and was prepared to embark for the first time in a century on the world game of bargaining in tariffs.

By the various bilateral trade agreements adopted at Ottawa in 1932, Canada took advantage of Imperial sentiment to secure her great market in the British isles and to expand her sales to Imperial countries by giving British and Imperial goods a moderate preference over American and other foreign goods in the Canadian market. It took some time for Washington to change its habits in response, but the Roosevelt administration finally secured legislation enabling the United States to bargain for tariff reduction in bilateral pacts, and its first great accomplishment under the act was the trade treaty with Canada of November, 1935. This in turn necessitated a new Anglo-Canadian agreement and the process reached something like a logical conclusion in November 1938, when the United Kingdom, the United States and Canada agreed upon regulations governing by far the mightiest triangular exchange of commodities in the world.(i) They had already worked out arrangements which ensured for their currencies a rough parity and a stability which were quite remarkable considering the violent disruptions going on in the world. In effect, the United States had broken inside the British system created at Ottawa in 1932, at the price of reducing her own tariffs and, in particular, of recognizing as normal the flow into the United States of a large number of raw and semi-manufactured products from Canada. This great commercial compromise provided the most comprehensive illustration of an "economic stabilization," to which we responded readily.

The most striking fact in Canada's trade with these two countries is that on current account we are usually debtors to the United States and creditors of the United Kingdom and the rest of the world.(2) Sometimes our debits

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2. See chart. IX

(i). The trend towards the formation of economic blocs is apparent

IX

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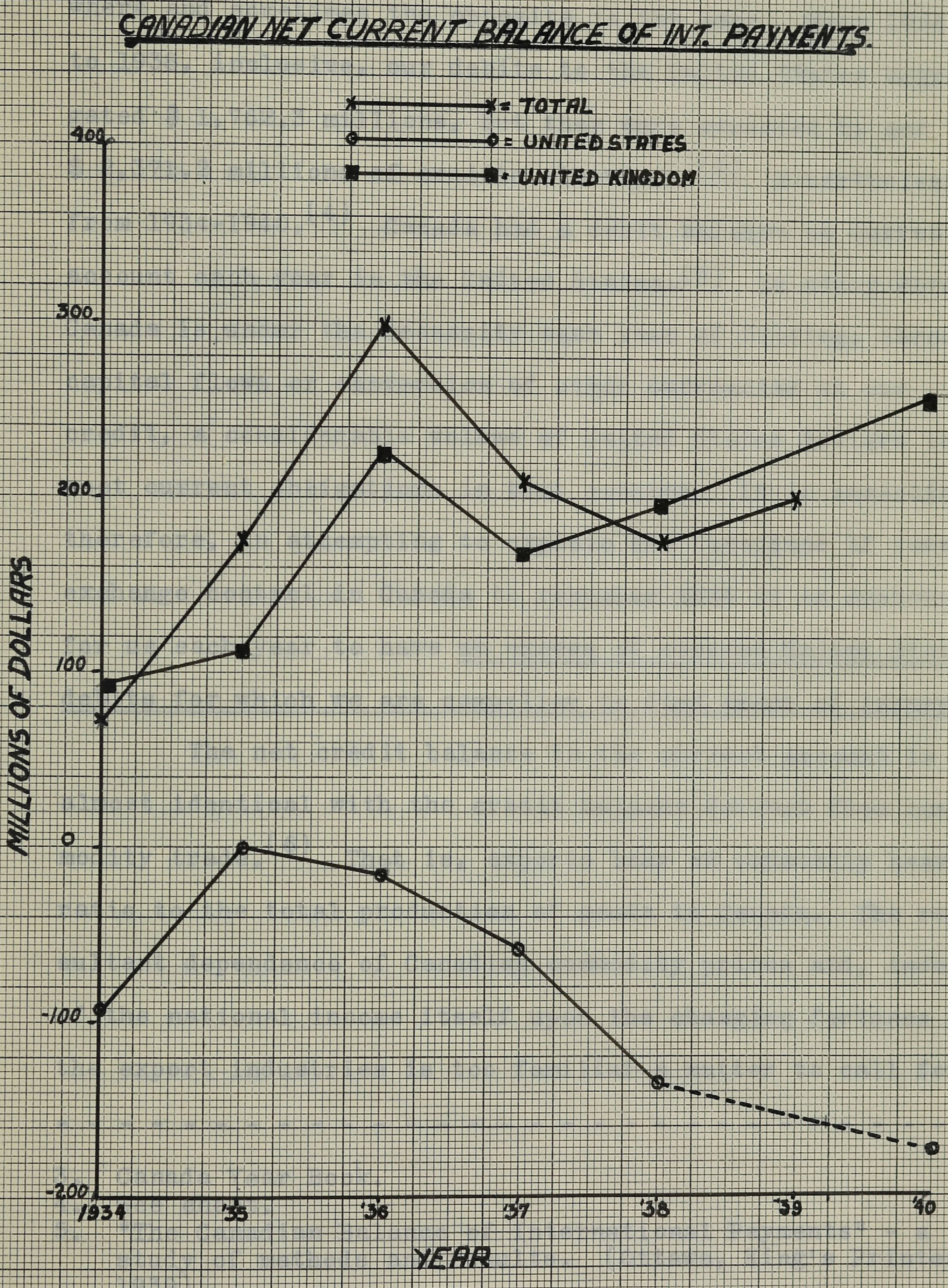

SOURCE: SEE APPENDIX

to the United States are in excess of our credits elsewhere and sometimes the opposite is the case. From 1926 to 1938, inclusive, our debits to the United States aggregated $ 1,762.3 millions, but they were exceeded by our $ 2,371.2 millions of credits elsewhere.(3) Nevertheless, from 1934-1940,(4) Canada had a debit balance on current account each year in the United States.(5) In other words, Canada is under the necessity each year of finding, through capital flows or conversion of other currencies at our credit, a considerable volume of United States dollars to meet current obligations in that country. It is essential, therefore, in attempting to explain the functions of foreign exchange control in Canada to remember that it is customary for us each year to have an excess of current United States debits for which we are compelled to find means of payment.

The net credit balance in the current account is almost identical with the credit balance derived from commodity trade.(6) That is, exports bear an unusually heavy ratio to the total production of goods in Canada. The resultant dependence of Canadian commodity prices and, indeed, of the national income itself upon the changing fortunes of the export industries is too familiar a matter to call for

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3. Canada Year Book.
4. See chart.
5. "The Canadian Balance of International Payments" - a study of methods and results. (Ottawa, King's Printer, 1939).
6. Ibid.

any elaboration. The aggregate net current balance from 1931 to 1939 was \$ 1,092 millions.(7) This surplus was used to reduce Canada's net indebtedness abroad. Further, the years 1934-1940 witnessed a great increase in gold exports to the United States.(8) There was no difficulty, therefore, so far as our balance of trade is concerned.

In 1935, Canada's debit balance on current account with the United States equaled \$ 133 million. There was no inward flow of capital from that country to counteract this debt. In truth, there was a capital efflux which took the form of branch plant transactions, insurance payments and net retirements of Canadian securities held in the United States.(9) The large credit accounts with Great Britain and the rest of the world paid for the United States imports into Canada.

The natural function of national currencies is to be exchangeable without any limitation for all other currencies, and through them for goods. Prior to the declaration of war, our credits with Great Britain and the rest of the world were used to purchase American dollars and settle our debit current balance with that country. The surplus was then utilized to retire Canadian securities held in both Great Britain and the United States.

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7. Canada Year Book.
8. 1934 - \$ 86,829,000; 1937 - \$ 111,480,000; 1940 - \$ 2,622,330. Federal Reserve Bulletin, April 1941, pp. 363.
9. Canada Year Book.

As long as there was a satisfactory demand for sterling on the United States exchange, Canada could use her British credits to meet American debits. The technique involved is not germane to our analysis. Throughout the pre-war period, except for the brief unsettled years in the early 30's, this condition prevailed. There was therefore little need for Canada to consider bilateral balances with other countries. Her multilateral balance of international payments was a sufficient criterion to examine.

War altered that position. The international balance of payments from a multilateral viewpoint is now for practical purposes meaningless. The figures remain, relatively altered of course, but they have lost their former significance. The important factor now is the establishment of bilateral clearings with each Canadian trading partner. An analysis of the international balance of payments is of little importance compared with the composition of the series of bilateral balances which make up the total.

The adjusting mechanism has been temporarily suspended : sterling is no longer strong relative to the American dollar.(10) If Canada tried to meet her dollar debts with sterling credits, the effect would be to push the pound still lower, resulting in greater difficulties to Great Britain. At themsame time, a depreciated pound would be of little value to Canada in meeting her debts to the United

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10. The pound sterling was pegged at $ 4.02 and fell to $ 3.50 on the free market. Cf. Gazette.

States. That is, the terms of trade would move against us. Hence, until such time as the pound sterling can be brought to closer parity with the United States dollar, whether by increased British exports, liquidation of British held securities and/or what is practically the only remedy - American loans (which are now barred) Canada cannot meet her dollar debits with sterling credits. Moreover, the British are making most of their payments in Canada by means of liquidation of securities. This means that no devisen ~~are~~ is forthcoming at all. As a result, (barring American aid), Canada has to achieve a bilateral balance of payments with the United States and with those countries whose currencies are tied to the American dollar. There are no longer outside "props" to support our debit balance. This is the fundamental change which the war has brought to the concept of the balance of international payments and is the underlying reason for foreign exchange control in Canada.

Canada's Foreign Exchange Control Board was created on September 16th, 1939 under the authority of the War Measures Act.[11] In the annual report of the Governor of the Bank of Canada to the Minister of Finance, the following statement is made: "Since commencing operations in 1935, we have had the opportunity of developing an organization which could provide

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11. Order in Council P.C. 2716 of September 15th, 1939, issued pursuant to Chapt. 206. Revised Statutes of Canada 1927, as amended November 22nd, 1939 by Privy Council Order 3799.

a nucleus of experienced men for work of an emergency character. Under modern conditions, whether of war or peace, it seems essential that a central bank should be able to respond to such demands."(12) The Bank of Canada certainly did. The remarkable feature of the entire scheme is the comparative ease with which this far-reaching form of control has been superimposed upon the business structure of our community, with a minimum of inconvenience and disruption to ordinary everyday business. The Board realizes full well the handicaps which exchange control attaches to ~~business~~ trade. The officers of the Board(13), and officials connected with it, endeavour to avoid all delays on permits and enquiries. Procedure is simplified, mistakes admitted, and amendments passed as soon as possible. It is their policy to avoid arbitrary procedure by consulting all pertinent interests. Suggestions are welcomed and the whys and wherefores explained whenever possible. In general it places emphasis on efficiency and co-operation rather than on inefficiency and compulsion.

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12. The Annual Report of the Governor of the Bank of Canada to the Minister of Finance.
13. See chart. "The first members of the Board shall be, G.F. Towers, Governor of the Bank of Canada; W.C. Clark , Deputy Minister of Finance; Hugh Day Scully, Commissioner of Customs, Dept. of National Revenue; L.D. Wilgress, Director of Commercial Intelligence Service, Dept. of Trade and Commerce; and Norman Alexander Robertson, First Secretary, Dept. of External Affairs. (66,504) Commercial Clearing House, Statutes of Canadian Exchange Control.

We have enquired at the outset[14] "whether exchange control is a technique in a secular trend or merely an emergency measure". Our analysis has led to the conclusion that in most cases devisen controls were part and parcel of the entire Neo-Mercantilist trend and were merely the manifestation of underlying economic maladjustments. In the former sense, Canada falls into the shadow of this schema.

"The Bank of Canada itself", writes Prof. A.F.W. Plumptre, "is a symbol of the trend toward state intervention and control."[15] Nevertheless, the Bank of Canada, certainly was not, and did not pretend to be the direct antecedent of the Foreign Exchange Control Board. The Bank provided the important machinery; the formation of the Board was an exigency.

It is also interesting to note that in 1935 "an Act respecting the establishment of an 'Exchange Fund'[16] was passed, which would have, by revaluing the gold held by the Bank of Canada at current market price, set up an account similar to that of the Exchange Stabilization Funds in the United States and Great Britain. Although the necessary proclamation to put it into effect was not issued until 1939, evidently the monetary authorities recognized the desirability of such an account and were prepared for any eventuality in

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14. Introduction, pp. 1.
15. A.F.W. Plumptre, "The Bank of Canada", Parkinson ed. Canadian Investment and Foreign Exchange, pp. 167.
16. Commercial Clearing Documents "Canadian Financial Regulations".

~~in~~ which it might prove useful. Even in Canada, the germs of exchange control are to be found in the Neo-Mercantilist trend of étatisme. There is no resemblance, however, between the underlying economic maladjustments which led to the establishment of controls on the Continent and the exigencies of war finance which Canada's strong foreign trade position had to face.

The second problem on the agenda of this thesis was as follows: are the characteristics of exchange control universal or specific to the economy in which the controls exist ? We have seen that devisen control is an integral part of the economy to which it belongs. The Canadian situation is ~~controls are~~ no exception to this rule. United States aggregate investment in Canada is nearly four billion dollars. Long-term investments (direct and portfolio) comprise $ 3,722,000,000, short-term add $ 59,000,000 producing a total of $ 3,781,000,000.[17] The total investments of the United Kingdom and British Empire countries in Canada amounted at the outbreak of the war to $ 2.6 billion.[18]

"Entering war, Canada faced these distinct problems in her international financial relationships:

1) She had to ensure that her current receipts of hard currency would be utilized with maximum effectiveness, having regard to the necessity of vital war imports and at

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17. Federal Reserve Bulletin, April 1941; pp. 313.
18. Donald Gordon, Deputy Governor, Bank of Canada. An address "Some Current Problems", April 10th, 1940. pp. 16.

at the same time meeting her contractual obligations to non residents.

2) She had to ensure that her foreign assets which might later be urgently needed for war purposes, would not in the meantime be dissipated by uncontrolled exports of capital which would in addition disorganize her domestic investment markets and seriously interfere with her program of war financing."[19]

This anomaly precluded stringent exchange controls. Although the administrative techniques are similar to those outlined in chapter III,[20] Canada learned at an early date that exchange control must be thoroughgoing or not at all.

To control the items on capital as well as current account the following principles were applied. The Foreign Exchange Control Board was given a monopoly of devisen, including the immediate compulsory sale of holdings in banks and private institutions. The official rate of exchange was fixed and no other non-official rates are to be published; the export of devisen, foreign securities and domestic currency have been disallowed unless permission is granted by the authorities; a strict balancing of each separate transaction was initially attempted to guarantee that devisen proceeds for exports would be forthcoming; run-on-accounts were introduced

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19. Ibid. pp. 17.
20. It is impossible here to go into the mass of legal detail concerning Canada's exchange regulations.

wherever necessary to obviate unnecessary bureaucracy; capital exports in the form of loans were prohibited; all devisen were to be sold to the Beard or its satellite institutions unless permission was granted otherwise; foreign securities had to be registered with the authorities; the transfer of funds between foreigners' accounts ar between foreigners' and residents' accounts and vice versa was made illegal; the importation of foreign securities and domestic currency came under the jurisdiction of the Board; exports, imports, foreign travel etc. required permits and transactions with certain countries and certain currencies were prohibited except under government auspices.[21]

The broad effect of exchange control has been to build a wall around Canada economically, and to bring all external business under purview of the government. The laxity in foreign remittances to the United States is a necessary resultant of the two mingling intertwined economies. Exchange control is always relative to its political, geographic and economic atmosphere.

The initial function of exchange control is usually to prevent capital flight. With all diffidence to the Canadian authorities, the writer has reason to believe that both foreign and domestic withdrawals prior to the establishment of controls were rampant. The Royal Bank Monthly estimate ~~of~~ for

21. Cf. Canadian Financial Regulations. Commerce Clearing House.

April 1940 shows that "other capital movements" had increased to minus $ 144 million, while the average between 1934 and 1938 stood at minus $ 88 million.[22] It must also be noted that security transactions on balance equaled plus $ 72.1 million, while the average for 1934-38 stood at 18.5 million. Further "With the commencement of hostilities there was an immediate increase in United States demand for both forein and domestic goods. Imports rose substantially, and from October 1939 to January 1940 averaged 30 per cent higher than in immediately preceding months."[23] This was also the period in which for one month Canada actually had an <u>active</u> balance of trade with the United States. The situation resembles that of Germany in 1931. Capital flight results in commodity flight. Even discounting omissions which were probably very great prior to the outbreak of war, these statistics seem to bear out the conclusion that capital flight was an important phenomenon during the crisis. Foreign exchange control blocked these disturbing capital movements.

In Germany foreign exchange control also began as a technique to control capital flight. It was perverted into a bureaucratic ~~technique~~ system which reached its nadir in an autarchic commercial policy. "The contact man became a curious new business aid in all economic relations."[24] Balogh only skims the surface when he calls it "the fulcum of the central

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22. Royal Bank Monthly Letter of April, 1940. Estimate of Canadian Balance of International Payments.
23. Federal Reserve Bulletin, January 1941, pp. 4.
24. Guenter Reimann, <u>The Vampire Economy</u>, (N.Y. 1940) preface VIII

control of all important primary commodities."[25] In truth, it became a device to control the <u>economic</u> and <u>political</u> destiny of Europe. The technique was successful, in collaboration with other Neo/mercantilist measures, to insulate the "autarchic bloc" from the rest of the world. Production rocketted and the national income nearly doubled. This was made possible, writes Dr. Meyer, by the exchange control system which has all the earmarks of the classical gold standard and "led to just such a liberation of goods and services for domestic consumption as there would have been under the price mechanism of a free exchange economy."[26]

That exchange control may aid authoritarian planning is true; that it is a universal system is false. Like all other impediments to trade it greatly aggravated the decline of international trade between 1931-1940.[27] Moreover, the restoration of the normal movement of capital from country to country is an integral part of the reconstruction of a system of free exchanges. Exchange control precludes such a restoration. Price controls, commingled with controlled exchanges have no semblance of an international gold standard. The camouflaged devaluations which set in wherever controls were applied clearly proves that relative production and money indices are still masters of the exchanges.

Through control of foreign exchange transactions

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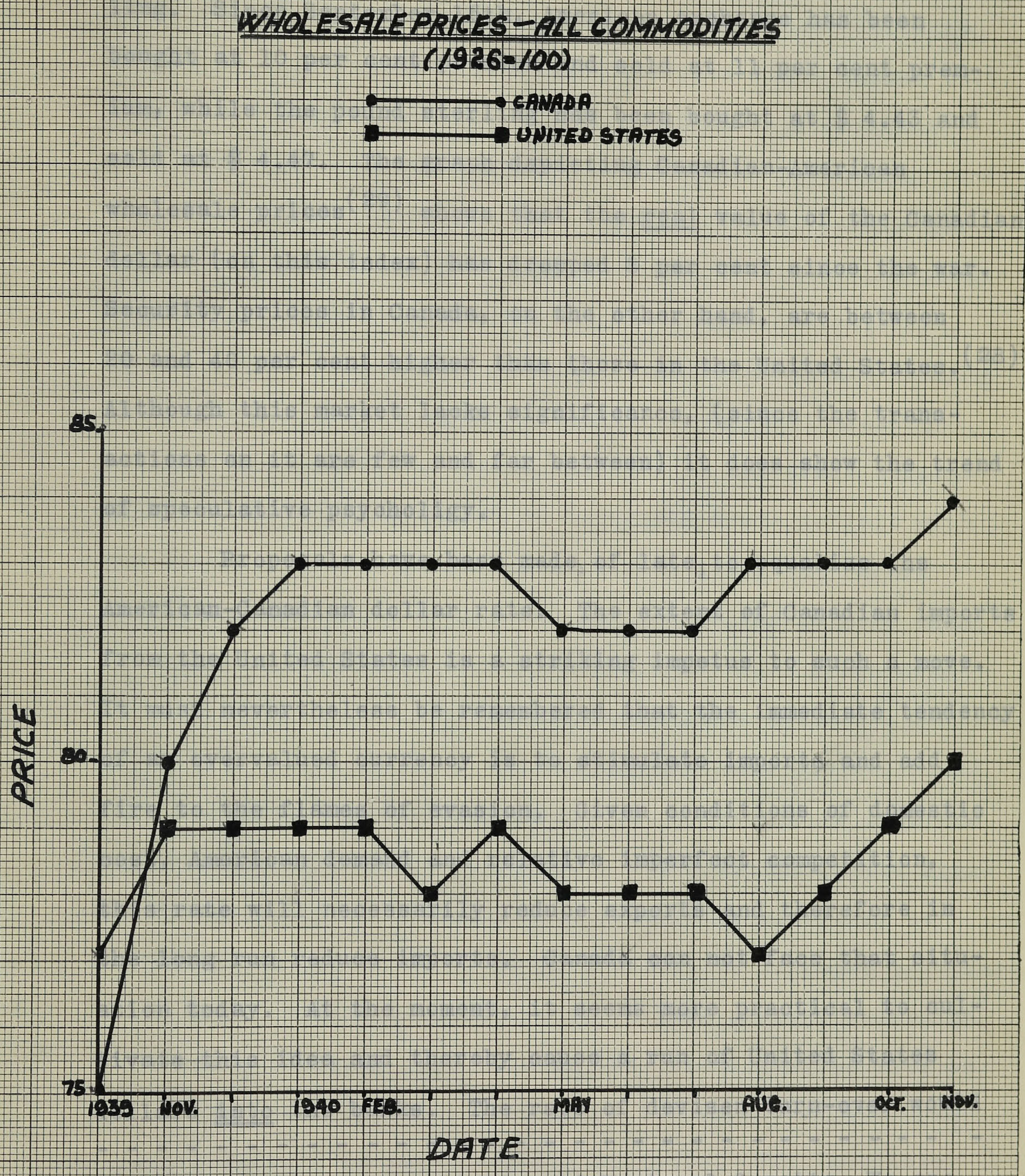
25. Thomas Balogh, <u>The National Economy of Germany,</u> Economic Journal, Vol. 48, pp. 481.
26. Quoted by Ellis, op.cit., pp. 465-466.
27. League of Nations, World Economic Surveys.

No XI.



SOURCE: FEDERAL RESERVE BULLETIN (JAN. '41) the Board has so far been able to stabilize the Canadian dollar in terms of the American dollar and the pound sterling. Since September 16th, American exchange has been bought at 10 per cent premium and sold at 11 per cent premium, while the pound sterling has been bought at \$ 4.43 and sold at \$ 4.47. The graph depicting Canadian-American wholesale prices(29) shows that the real value of the Canadian dollar (on this index) has dropped 8 per cent since the war. Security prices in Canada, on the other hand, are between 20 and 40 per cent higher than those in the United States.(28) Although this market lacks significance, (since the transactions on it are few and far between) it does show the trend of speculative psycholigy.

Proposals have been made, of late, to equalize the American-Canadian dollar rate. The extent of Canadian imports from the United States is a striking impetus to such a move. It must nevertheless be remembered that the immediate tendency of an overvalued currency is to stimulate imports and add fire to the flames of evasion. Given conditions of domestic cost, American demand and relative imperfect competition, this rate will necessarily reduce exports and therefore in the long run reduce imports. Canada can not face that situation today. At the moment, it seems more practical to cultivate this idea and thereby cause a run of United States dollars into the banks. The rate of devisen turn-over would

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28. Federal Reserve Bulletin and Montreal Gazette, We are only dealing with securities which are quoted on both exchanges.
29. Chart No. XI.

therefore increase and hoarded funds would be liberated. Our foreign exchange position would probably be strengthened. Graph No. XI also shows the tendency of American wholesale prices to rise relative to Canadian prices since August 1940. There is reason to believe that this trend will continue and bridge the gap between American-Canadian purchasing parity. The equilibration of the two currencies at par is the most desired monetary policy at the moment both by the people and the governments of Canada and the United States.

There are several external factors which are leading in the same direction. The Dominion Bureau estimates for the year 1940 show a probable increase in our trade surplus with the United Kingdom and an increased trade deficit with the United States. Comparing 1939 with 1940, the former probably jumped from around 200 million dollar to more than 350 million, while the dollar shortage may have grown from 150 million to more than 350 million. These estimates indicate the straits in which the Foreign Exchange Control Board must be. From the declaration of War to the end of 1940 the repatriation of Canadian securities owned in the United Kingdom was over 250 million dollar. This year, according to figures given by the Minister of Finance, it is hoped to transfer some 500 millions in securities. This gradual reduction of Canada's external debt held in the United Kingdom will be one of the most important results of the impact of war upon Canada's balance of international payments. The immediate effect upon our standard of living will be hardship. In the long run, we may become a relative creditor nation. The Canadian securities in English hands are becoming more and more deplete. Not only do we have to finance our increased American debit balance but we will also be obliged to pay for our exports to Great Britain. We are becoming more and more dependent upon the American economy for aid. Canada shows no signs of wanting a complete political merger with her powerful neighbour, and the United States no signs of wanting to force one. Nevertheless, the two peoples were never so closely bound before in their history. The present emergency must lead to greater economic co-operation and therefore to the liberation of the exchanges.

Austria is an example where a neighbourhood of equilibrium was attained through exchange control. In our country the method of relaxing the exchanges which deserves consideration is the system under which the control authorities will allow part of the foreign currency obtained for exports to be sold at free market rates, though during the transition the general control of exchange may be maintained and the official rates remain unchanged. In this way, we will be able to sell goods more easily in the American market and increase our assets in the currency of that country. But there is a danger that, if this system is applied to too restricted an extent, the price of the Canadian dollar may be unduly depressed owing to the narrowness of its market. This policy can be commingled with the co-operation between the Foreign Exchange Control Board and the American Exchange Equalization Fund. The latter body is in a position to "sop up" an excess amount of Canadian dollars which may depress the market temporarily. The Canadian authorities, on the other hand, can preclude the importation of goods which are not essential to the war effort. The supply of and the demand for United States dollars can in this way be equilibrated. At the end of, say, every six months we can rebuy our Canadian dollars with "tourist bills" sold at a discount to the Exchange Equalization Fund, equal to the loss incurred by the American authorities. Canadian tourist trade and American business would profit and the two economies would be gradually freed from the burdens of exchange control. In the case of Canada, it may be necessary to take cautious steps to prevent the market from being disorganized through speculation and capital flight. Ultimately the merging of the American-Canadian-British economic structures is an inevitability.

If political ideologies and economic rivalry are to inhibit a maximum utilization of international resources, then one must concede the fact that the larger the economic unit, the greater are its potentialities for economic specialization. Larger economic units, composed of trustworthy, mutually indispensable and complementary states must therefore comprise the order of to-morrow.

Finis.

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