INTERNATIONAL TRADE COURSE

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The Economics of the Dollar Shortage

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INTRODUCTION

Dollars are available in plentiful supply to all countries, and are meeting every demand, provided that the right price is paid for them. But that right price can be determined only in a perfectly free market. The reason why traders in many countries are pinched for dollars and are therefore disabled from importing American goods is that responsible governments have fixed rates of exchange in their own currencies which would pay less for dollars than dollars are actually worth. Inflation depreciates the purchasing power of money in circulation, but governments attempt to disguise that by arbitrary fixation of prices applied to both internal and external trade, and with results that are disastrous. The effect of inflation is to restrict and stop imports, and on the other hand to boost and subsidise exports. Quite deliberately, it is part and parcel of protectionist policy destined to give special privilege greater sway. These matters are treated in Dr. Sven Rydenfelt's paper "The Economics of the Dollar Shortage." It is not confined to ridding our minds of the "dollar gap" folly. It is an exposure of the fallacies associated with the arbitrary control of rates of exchange. That particular argument sufficiently proved, the author accomplishes his purpose without necessarily raising wider monetary and fiscal questions, such as: how inflation is to be arrested, sound money established and how governments are to raise their revenues and balance their budgets without piling taxation and debt upon the producers of wealth. Short of that exposition, Dr. Rydenfelt's paper supplies a most valuable chapter to the economics of free trade.

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The Economics of the Dollar Shortage

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Among the host of diseases that have infested the community, especially since the termination of the second World War, the so-called dollar shortage has taken an important place. The dollar shortage, however, is only one form of the disease, and the shortage of other foreign currencies is often as serious.

Usually the disease is looked upon as an affliction comparable with the Black Death or the plague; an epidemic carried by the wind, nobody knows whence or why. Or could the trouble be taken to be—as some regarded the plagues of old—the judgment of God for the wickedness of mankind?

But as economists we have to look at the problem from the economic point of view. In that light the causes of the dollar shortage are at once not so obscure. A closer examination will show that this disease must be diagnosed as entirely self-inflicted and a direct result of human actions.

Our money system, of course, is nothing but an improved and readier form of old-time barter. Our monies are merchandise and obey exactly the same economic laws as other goods. Thus the monies of various countries have their respective prices, although we usually complicate matters by calling these prices *rates of exchange*. When the Swedes (with their money unit, the crown) say that the dollar rate of exchange is 5.18, or the Danes (with their unit, the crown) that it is 6.92, they are, of course, simply stating the price of a dollar in Swedish and in Danish crowns respectively.

When we talk nowadays about having "fixed" rates of exchange, that simply means that we have prices for foreign currencies which have been fixed by the State; in other words we have *price control*. The antithesis of that system is, of course, to have free rates of exchange.

If price control is to have any meaning at all, here or elsewhere, it means that prices are fixed so as to differ from the free market prices. But prices thus fixed must always upset the balance of supply. There will be either a shortage or a surplus of the article in question.

In a free market, prices have a tendency to adjust themselves at a level at which supply and demand will be fairly evenly balanced. There may, of course, occasionally be in such a market a shortage or an abundance of certain articles because of the tendency in the prices to lag behind; but any real shortage or any actually unsaleable surplus practically speaking never obtains.

If, however, you *fix* the price below the market level, that is, make an article cheaper, demand will almost always increase. At the same time it will become less profitable to produce the article, and supply will decrease. The result will inevitably be a shortage. If, on the other hand, the price is fixed above the market level, you get the converse result. Demand will decline, whereas production will be stimulated. The result will then as inevitably be a surplus.

During the crisis in the thirties the State believed that it would be able to help industry out of its distress by fixing the prices of its products at a higher level than the market price. And though a large section of the industrial machine came to a standstill on account of depression and unemployment, we had a great unsaleable surplus of wheat, cotton, coffee, pork, meat, etc., which in many cases simply had to be destroyed.

During and after the second World War the State thought, for reasons of its own, that it ought to fix prices below the market level. And although at that time we had full employment, and all wheels of industry were humming, we were left with a shortage of a number of necessaries of life.

The dollar shortage and the shortage of other foreign currencies has arisen in exactly the same way. We have not been willing to accept the market prices, but have fixed so-called official rates of exchange. In addition, the national bank has monopolised the purchase and sale of foreign currencies. As the prices—the rates of exchange—have usually been fixed below the market level, demand has been too great in relation to supply, and we have had a shortage. The position has become still worse because through this price-fixing the " production " of foreign currencies—via export—has become less profitable and has therefore slowed down.

Let me illustrate this by an example. The official price of dollars in Sweden as mentioned before, is 5.18 crowns. The pronounced shortage of dollars shows us, however, that this price is too low. Many signs indicate that it ought to have been about 6.50 crowns. What is the effect on foreign trade of this low price? For the Swedish importer of American goods (who, in effect, is the buyer of dollars to pay for them) it means that he will

obtain a $100 article for 518 crowns, whereas in a free market he should have paid 650 crowns. On account of this low rate, *American dollar articles become cheap*; everybody wants to buy from America, and the *demand of dollars consequently becomes very great*.

For the Swedish exporter of goods to America (who, in effect, is the seller of dollars) it means that he will get 518 Swedish crowns for a $100 article, whereas in a free market he would have got 650 crowns. He will thus be paid 20 per cent less than what a free market would have assured him. It is understandable that in these circumstances he will more often than not find the prices obtainable in the American market *unacceptable and unprofitable*. The consequence is that the export to the U.S.A. progressively dwindles, which is another way of saying that the " production " of dollars in Sweden is insufficient in relation to demand.

In such a situation, the dollar supply in the national bank will melt away like snow in the spring sun; and unless the price—the dollar exchange rate—is quickly altered, the supply will simply run out. With the demand continuing greater than the supply, and the purchaser's need for dollars exceeding what the exporter can deliver to the national bank, there is in this situation no alternative but to introduce rationing of the article in short supply. Anybody wanting to buy dollars for one reason or another will have to apply for them, and only those applications will be granted which the national bank or the responsible government department itself judges to be expedient. This is the situation to-day.

Why does a regulated régime as a rule tend to keep the prices —the rates of exchange—for foreign currencies below the market level? Several reasons can be given, but they are all based on false assumptions and the results of pure wishful thinking. First of all it is believed that by this system imports could be cheapened; a $100 article will now cost the importer only 518 crowns, whereas at a proper rate of exchange should have cost 650 crowns. This conclusion is correct if you look at the immediate result, but in the long run it is completely false. For the system also means that the exporter will get only 518 crowns for a $100 article, whereas at the proper rate he should have had 650 crowns. In reality the same effect is produced as if exports under free rates of exchange were burdened with a 20 per cent export duty. As it is, there are the complaints about the dwindling Swedish exports to the U.S.A. and Swedish producers are reproached for their inability to compete successfully in the American market!

The argument that imports are cheapened is a false argument. In the long run the only means of paying for our imports is by our exports. What benefit can we have from cheap imports if our exports fade out? We shall have nothing to pay with. Moreover—if the problem is merely to get cheap imports, why don't we fix the dollar rate at 2.50 crowns? Or why not a half crown? A rate like that would surely make imports really cheap!

Rates of exchange that are too low act as a noose round the neck of export. The tighter the noose, that is, the lower the rate, the greater will be the part of export that is strangled. But as there must be exports in order to have imports, the latter will be strangled to the same extent.

Rates of exchange that are too high are by no means better. Suppose that in Sweden we fixed the dollar rate of exchange at 10 crowns instead of at the rate of 6.50 crowns, which the market level warrants. The exporters would then get 1,000 crowns for a $100 article instead of 650 crowns. That would amount to the same thing as an *export subsidy* of more than 50 per cent. Under these conditions the export to the United States would be highly profitable for the exporters, and we should get a tremendous export rush across the Atlantic. But at the same time the American imports would become so expensive in Sweden that nobody could buy them, and the import from the the U.S.A. would fall away completely. The system would in fact have more or less the same effect as a prohibition against the import of American goods. But export is not an aim in itself; if we got no imports in exchange for exports, it would be senseless to export at all. The system would simply be an exquisite illustration of currency-fed dumping.

In Sweden we have an example of such a system in our trade with Argentina. The official rate of exchange for pesos has been absurdly high, and as a result the export to Argentina has become particularly profitable, and tempting from a Swedish point of view. At the same time the price of imports from Argentina has so risen that practically all import has become impossible. In consequence we now find ourselves with large frozen assets in Argentina without possibility of converting them into goods on reasonable terms.

Rates of exchange that are too low will cause exports to shrink and imports to swell. Rates of exchange that are too high will have the opposite effect. In both cases a dis-equilibrium is produced followed soon by a decline in the volume of foreign trade. It is easy to show mathematically that the volume of foreign trade is greatest when the rate of exchange is at a level where the supply of, and the demand for, foreign currency balance one another. And that, as is well-known, is the rate of exchange which is reached in the free market.

The object of managing the rates of exchange is to make them differ from the rates that a free market would determine. Otherwise management has no sense. But whether the rates are fixed below or above the market level, the result will inevitably be a

decline in foreign trade; and the greater differences in the rates, the greater will be the decline in trade. And with that decline so also is lost the gain otherwise derivable from the international division of labour. The benefits of the division of labour redound upon our standard of living to a degree considerably greater than people generally recognise. The system of managed rates of exchange cannot but result in a reduced standard of living.

False rates of exchange will cause decrease of foreign trade and, with that, a decrease in the supply of goods in general. Thus they are factors that make for increased prices. Free rates of exchange simply register the value-relationship between the domestic and the foreign currency, exactly in the same way as a clinical thermometer registers the temperature of the body. The patient will not recover any quicker by tampering with the thermometer. If our own currency depreciates in value in terms of other currencies, it is nearly always due to the result of our own internal monetary policy, we habitually attempting thereby to live beyond our means.

In these times of inflation (currency debasement) many people try to put the blame for their own inflation upon conditions abroad. Let us explore this notion by offering the following illustration. Suppose that a country A has a currency—call it *sequins*—of the same value as Swedish currency so that 100 sequins equals 100 crowns. Suppose that through various circumstances—chiefly an irrational economic policy—there should be a prodigious inflation in country A. The price-level in that country is doubled, the sequins consequently losing half their value. Let us further suppose that the internal value of the Swedish crown has remained unchanged during the same period. Under a system with officially fixed exchange rates, 100 sequins will still cost 100 crowns. But as the price-level in country A has been doubled, this means that prices of Sweden's imports from A are also doubled, just because it now takes twice as many crowns to purchase the sequins in order to pay for the goods. At the same time, Swedish exports to A will become exceedingly profitable. The exporters will be paid twice as much as before. Swedish trade with A will be thrown completely out of balance and eventually will inevitably dry up.

What would have been the course of events if there had been a free market rate of exchange? The rate of exchange would then have continually registered the changing relative value of sequins and crowns. When sequins had fallen to half their original value, people in Sweden would have been able to buy 100 sequins for 50 crowns. This would mean that the article which at the outset cost 100 sequins in country A, and to-day costs 200 sequins, could all the time have been had for 100 crowns in Sweden. Exactly the same would have applied to the export trade. The exchange of goods with country A would have continued without interruption, completely unaffected by inflation. No inflation abroad can penetrate the frontier of a country which has free rates of exchange. There is just one disadvantage attaching to free rates of exchange; it is that if, in any event, inflation should be resorted to in a given country, it is impossible to throw the blame for that on the foreigner!

Another argument against our rates of exchange being settled in a free market is that devaluation would mean a recession in the exchange of goods with other countries. It is maintained that we would get fewer goods from abroad in exchange for our own. This view is fundamentally mistaken. No manipulation whatsoever of our rates of exchange will alter the prices in the world market. A $100 article will still cost $100, whether we buy or sell it. Thus the real value-relationship of goods for goods can never be affected by alteration in monetary rates of exchange.

Do not interfere with the rates of exchange! Our money ought to be a stable standard of value, and its value in relation to other currencies should not be changed from time to time. The idea that we can arbitrarily alter the rate of exchange is based entirely on an error of judgment. The fact is that free rates of exchange are nothing but a pair of scales where the value of our own currency is weighed against the value of others. The Swedish crown (taking that as an example, for the same is true of the pound or any other unit of account) will be neither heavier nor lighter if we tamper with the scales. Its real weight is not affected by that. Generally speaking, we would prefer to see our crown weigh as much as possible and when we fix lower prices for foreign currencies than would be payable in a free market, it is because we are actuated by that wish. But the real weight and value of the crown is of course completely independent of all manipulations with the scales . . . . If you will not adjust the rates of exchange to agree with the scales, there is no means of establishing an equilibrium in foreign trade other than to slash the excess of imports over exports. The more you tamper with the rates of exchange, the more will export shrink, and the more you must cut down your import. If you travel sufficiently far along that road you will at last strangle your import as well. In pursuance of such a policy, the final really radical remedy for this lack of balance must be to prohibit foreign trade altogether. Thus you will cure the malady as certainly and as effectively as you would cure a headache by decapitation! And with much the same result to the patient!

The usual objection against free rates of exchange is that they will mean continuous fluctuation and thus render difficult all calculations in foreign trade. As a rule business people emphasise their desire for stable rates of exchange, thus to be on firm ground

with their calculations. Unfortunately the reply must be that this is just one of those pious and ethereal wishes that can never come true in this imperfect world of ours. We live in a dynamic and changing world where all values are constantly changing. The currencies of various countries are by no means exceptions to this rule. Certain countries succeed in keeping the value of their currency comparatively stable; in others, inflation is a policy of indirect taxation—the government paying its accounts with newly printed money.

Even countries with managed currencies must sooner or later allow variations to find expression in altered rates of exchange, although they usually postpone that as long as possible. Two alternatives face them, and only two. One is the continuous and responsive adjustment of the rates of exchange which in a free market reflects the actual changes in relative values. The other is to suffer the sudden and violent alterations in the rates of exchange, which are a feature of the managed exchange-market, as for example when the dollar value of the Swedish crown was changed in July, 1946, from 24 to 28 cents, an increase of about 17 per cent, and when in September, 1949, the rate of exchange was lowered from 28 to 19 cents, a decrease of more than 30 per cent. Which of the foregoing alternatives is to be preferred from a business or calculation point of view?

But a system with free rates of exchange has other qualities that are not looked upon as merits in certain circles. Since we have learned by aid of subsidies how to manipulate the prices of various necessaries, we can no longer, with any exactness, estimate the extent of inflation by reference to a cost-of-living index. Free rates of exchange would here act as an extremely sensitive barometer that would register most accurately the course of the inflation, and thus at the same time give a continuous indication of the character of the economic policy of the country. No doubt this is one of the most dreaded qualities of the free system.

It is, I think, most unfortunate that the economic pattern of our society very often has become so complicated that it is beyond ordinary people to understand or comprehend. This must be deplored as it prevents people from perceiving the true causes of most of the afflictions and sufferings that disturb our managed economy. But undoubtedly it suits and satisfies the economic planners!

If you fix the price of an article too low—whether it be houses, electric energy, paper, or foreign currencies—there will be a scarcity of those necessities. We have fixed the price—the rate of exchange—of dollars and other currencies too low, and so we have our scarcity. The malady that has been labelled "dollar shortage" is entirely self-inflicted, a result of the official currency policy.

The way by which we can be freed from this plague is to have a free market in currency. This would have widely beneficial effects without any corresponding drawbacks. The advantages we imagine we gain by tampering with the currencies are but castles in Spain.

The dollar shortage is wholly and entirely created by ourselves, but openly to admit the fact would, of course, never do. In our desperation we look about for scapegoats on whom to put the blame. A common attitude is to throw the blame on the Americans and more particularly on their tariff policy. But whatever one may say, the decried tariff is in this instance completely innocent, since no tariff in the world can create a dollar shortage for us if we have a free currency market. The tariff is a barrier to world trade, and the higher it is the greater is the barrier, and the less foreign trade there will be, but when we in Europe and elsewhere blame the United States for the dollar shortage we reason like the wolf who accused the lamb drinking further down the stream, of muddying the water the wolf was drinking.

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