INTERNATIONAL FINANCIAL STABILITY AND MILITARY PREPAREDNESS

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Dr. Melchior Palyi, consulting economist, was born in Budapest, Hungary, on 14 March 1892. He was educated in Switzerland and Germany, receiving his Master's Degree from the Graduate School of Commerce and his Doctor's degree from the University of Munich. He also studied, but did not finish, medicine. His academic career includes membership on the faculties of the Universities of Munich, Gottingen, Kiel, and the Graduate School of Commerce of Berlin, where he became professor of Finance in 1929. His banking experience was obtained through the various branches of a major German bank and the Austro-Hungarian National Bank. He was foreign representative of the Hungarian Ministry of Agriculture. Later, he was engaged temporarily as an expert to the German Government's Industrial Nationalization Committee. In 1928 he became economist for th Deutsche Bank in Berlin. In addition, he was adviser to the Reichsbank, the central bank of Germany, from 1931 to 1933, and managing director of its Institute for Currency Research in Berlin. In 1933 he was guest of the Midland Bank, Ltd., in London and invited as guest lecturer by the University College of Oxford. He made his first visit to America in 1926-1927 as visiting professor at the University of Chicago. Since 1933 he has lived in America. His activities have included periods as visitin professor and research economist for the University of Wisconsin and Northwestern University. He has participated in broadcasts on the Univer of Chicago Round Table of the Air and the Northwestern University Reviewi Stand, and for a year was a news commentator for a Chicago radio station. In the summers of 1948 and 1949, he was in Europe to study the financial problems and systems of medical economics of the various countries. Since, he has completed a book on "Compulsory Medical Care." At present he is engaged as financial adviser to banks and other institutions, in addition to his current work as author and lecturer.

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DR. HUNTER: General Holman and gentlemen: Something over twenty-five years ago, as a young and not very wealthy instructor in search of learning, I spent two summers in Europe. It was a wonderful time for Americans to live and travel abroad. They could live like a king and go to the best hotels in Berlin, Paris, and Vienna for two dollars a day, meals included. Or they could live like a prince, as I did, for one dollar a day at first-class pensions.

The reason for that situation was that since the war the currencies of Europe had been on the downward march. The value of the franc, the mark, the shilling, and other currencies in relation to the dollar had fallen steadily, so that the American abroad was on "easy street." I remember we looked at the papers hopefully for still further declines, so that we could get even better exchange rates on our travelers' checks when we cashed them. To me, as no doubt to thousands of other Americans in that day, Europe's distress was chiefly regarded as an opportunity for a free ride. It was a wonderful free ride.

Now, I cite that to you to suggest how little experience Americans have had with the grim facts of real financial instability. It is difficult for us to grasp what real inflation means and has meant to peoples in other parts of the world.

Our topic this morning is "International Financial Stability and Military Preparedness." Our speaker, Dr. Palyi, is eminently qualified to discuss this subject, it seems to me, on three different grounds. The first ground is personal experience with the facts of financial instability as a native of long residence in Europe. He lived with it and through it in the difficult twenties and thirties. He is qualified on the second count because of a through academic training in the universities of Europe. And then, finally, and most important of course, he is qualified because of an extensive professional experience as a banker, as a government servant, as a consultant, and as an author.

We are delighted to have Dr. Palyi with us this morning.

DR. PALYI: Gentlemen, Professor Hunter presented me as an expert on international finance and especially on foreign exchange. Indeed, I have had some experience in those things. I went through five experiences with such things personally and became such an expert that I lost my money in every one of them. But that is not what I intend to talk about today, except in passing.

I imagine that you haven't had much experience with problems of financial stability and what it means at present. So I am going to make an attempt to present the problem specifically from the point of view of what we are faced with when expecting Europe to join us in the common effort. I will try to show why Europe is in such a bad material and psychological shape to do so, which is as we shall see, largely a matter of financial policies. So let me start, as it behooves, at the beginning, with just a couple of sentences on what was once the financial structure of the world.

As an example, you may remember the Portsmouth Treaty of 1905, which put an end to the Russo-Japanese War. The Czar's negotiator, Minister Witte, got away with comparatively favorable terms, although the Russian Army was thoroughly beaten, in full retreat, and its capacity to fight badly damaged by the rising wave of domestic unrest. Yet the Japs were moderate in their demands and willing to bargain. The chief reason was Japan's financial weakness. In spite of two successful bond issues on the London market, its gold reserve was dwindling and the ability to borrow abroad strained, while Russia still had a huge gold hoard and its credit in Paris and Berlin still was in excellent shape.

Fancy letting the outcome of a major war depend--and it was a very major war at that time--on such little things as the maintenance of one's gold standard or worry about what international bankers will think of one's credit, as if paper money had not been invented! Folks grown up in the era of world wars, of Bolshevism, Naziism, managed economies, and so forth, can scarcely imagine that less than fifty years ago a bitterly nationalist country like Japan would sacrifice the virtual certainty of additional conquest for the benefit of financial stability <u>after</u> the war. We are much more advanced by this time.

The survival of this philosophy--the philosophy, let me call it briefly, of the gold standard--as late as 1914 is illustrated by the fact that at the outset of World War I the best expert opinion in Europe--and I can testify what it was in Germany, as I was a witness to the fact that it was a generally accepted opinion in Germany; and I am sure the same was the case on the other side of the fence--agreed on one thing: That World War I could not last longer than a few months. Pretty soon the belligerents would be stopped dead, win or lose, by financial bankruptcy.

Indeed, the participants bankrupted themselves in no time. But that did not affect their will and ability to fight for several more years. They simply turned to paper money. So did Germany, especially, not having the advantage of American support. The Germans' rich international assets and credit facilities with which they went into the war wer soon exhausted. The blockade made vital raw materials from overseas inaccessible even in exchange for gold. By 1917 Ludendorff was ready to scrap money and finance altogether and to run the whole of Germany as a single barrack. That was to become everywhere the pattern of organization in wartimes, and in Soviet Russia at all times. But that was just the beginning of the new financial era in which we are living.

Before trying to appraise the current scheme in international finance and what it implies in military preparedness, let me sum up the pre-1914 setup. It operated on the principle that every effort has to be made to maintain the currency on gold at a rigidly fixed par; that budgets have to be balanced and debts paid in gold or its equivalent; that recourse to deficit financing for nonproductive purposes, such as war--and you will permit me to say that wars are not productive even though they may be absolutely necessary--is permissible only in extreme emergency, and then only long-term loans should be issued--in other words, you don't borrow from banks and make more money, but you borrow from the savers and thereby diminish the money supply in the hands of the public; that the tax-bearing capacity of the Nation should be used very sparingly; and that international credit, private and public, should be preserved by all means.

This was the sort of financial stability the pursuit of which had come to be regarded before 1914 as axiomatic, even in war, and for good reasons. In the capitalistic age, when private property was sacrosanct and money could move freely over national borders, "financial tinkering" would have defeated its own purpose. Oppressive taxation, monetary depreciation, and interference with the free flow of capital, would drive capital, the vital sinews of war, into hiding or into "flight." And without command over capital, foreign and domestic, men could be drafted, but they could not be provided with the means with which to fight.

On the other hand, a government whose credit was unimpaired could draw on this invisible capital and turn it into purchasing power to obtain the physical means of warfare. This was especially important to European nations facing recurrent armed conflicts. During the Crimean War, as an example, a Russian loan matured in London; the Czar's treasury could make private arrangement, with the full knowledge of the British Prime Minister, to renew it during the war. That may have been an exception; but it was a rule that in war, as in peace obligations had to be honored. We speak today of the Balkanization of international finance, but slightly thereby those countries which during the two Balkan wars of the 1910's made great sacrifices to keep up the service on their foreign debts. The result was that for all practical purposes the world constituted a single money market in which capital could and did flow freely in every direction.

This idyl was suspended and morally undermined in World War I. In the 1920's it was restored, but on the shaky foundations of manipulated interest rates, fictitious gold exchange standards, and artifically boosted capital exports, all of which broke down in the 1930's in the great depression and its socialistic or pseudosocialistic aftermath.

So much for an introduction, not for presenting myself as longing to go back to the old gold standard, which I know as well as you do cannot b restored at present; but the facts are worth being remembered.

Perhaps you are not familiar with the difference between a gold stan ard and a gold-exchange standard. A gold standard means basing currency on the gold reserve in some fixed proportion between money issued and gol held in reserve. A gold-exchange standard means stretching the gold rese arbitrarily. Suppose that Holland deposits part of its gold reserve in t Bank of England, not as earmarked gold but as a loan to someone in the Lo money market or direct to the Bank of England. The same gold now appears in two places. It appears in the balance sheet of the Netherlands Bank a in the balance sheet of the Bank of England. Both count it as part of th respective gold reserve, and both issue notes or other credit instruments against this reserve.

Naturally, the procedure can be repeated three or four times. Urugu may lend gold to the Dutch who hand the gold to the British who in turn redeposit it in the Federal Reserve Bank of New York. The same quantity of gold serves four times as coverage for note issues, expanding the worl currency base accordingly. If contraction occurs at one point, it has to be multiplied fourfold, too. The consequence is the kind of violent flustration in the credit volume and therefore in the whole economic setu which was handed us in the "Great Depression."

This technique is again being reconstructed at present in a very peculiar fashion. The French are doing a wonderful job along that line. A year or so ago the French Government borrowed 200 million dollars in New York from a banking syndicate headed by Lazards and the National City against collateral consisting of gold. In other words, they deposited gold in New York and borrowed dollars, paying some 3.25 percent for several years to come.

Now, why, if you have gold and can buy the dollars with it, do you have to use it as collateral for a loan and pay 3.25 percent? Here is th trick: The Bank of France left the dollars in New York. So, instead of the 200 million dollars in gold, France has now 400 million dollars in it reserve--at the monetary system's base..

The law permits the Bank of France to issue currency against gold (and dollars) and to a limited extent, a fixed contingent which is almost every year raised by Parliament, without gold coverage. Presently, the Bank of France can issue an additional 200 million dollars worth of franc without going to Parliament to ask for permission to issue paper money th has no gold backing. Thereby it can provide the additional currency with the appearance of being backed 100 percent by gold or dollars. Of cours the loan will have to be repaid. In the meantime, however, the French note circulation has risen and is now close to the all-time record of 1600 billion francs.

Well, when the loan is to be repaid, the note circulation should contract accordingly. You realize at once what instability is brought thereby into the French system, unless some other method is applied in the meantime to keep up the volume of money in circulation. Needless to say, plain greenbacks--a fresh "contingent"-- are likely to be the substitute that will not enhance the stability of the system.

But let us go further. Since the 1930's, international finance has been thoroughly revolutionized. From temporary emergency measures dictated by the depression and World War II, a new and perplexing financial climate evolved. Confiscating and hamstringing foreign capital rather than protecting and attracting it is a fundamental tenet of the new approach. It is essentially anticapitalistic; and it is, or has been, inspired by the "success" of the Soviet experiment along such lines.

An intellectual-moral erosion of the basis of international financial relations is what took place. It is the philosophy of full employment that has found its most cynical formulation in the famous words of its outstanding theorist, Lord Keynes, about the "humbug of finance," meaning that power can manipulate money as it pleases. The practical guidance in financial legerdemains along the road of full employment has been provided by the policies of Germany's equally cynical Dr. Hjalmar Schacht. These two most influencial economists of our lifetime were themselves intellectual products of the wild-boom and depression era after World War I, which exploded the economic and political ethics of the nineteenth century and of the gold standard.

By this time, the automatic gold standard is delegated to the ash can for all practical purposes. Mankind has freed itself from the "golden cross" on which it used to be "crucified." We are free to manipulate monetary systems, replacing the self-adjustments and self-restraints which the automatism of capital movements under the gold standard provided, with the wisdom--or arbitrary rules--of political managements. Such is, at any rate, the trend of public policy almost everywhere. But the problems of international finance are still with us. Nay; we are confronted with a problem of financial instability without precedent. It is among the most significant issues of a nonmilitary type burdening the preparedness economy of the Western World.

Paradoxically, the death of the gold standard has vastly increased the role of gold in international relations. Having lost its monetary throne, the king of the metals went underground, so to speak. As a king it was a pillar of stability; underground it helps to sabotage all efforts at stabilization. The greater a currency's "freedom" from gold, the less confidence it commands. The more thoroughly the international banker, that symbolic archvillain of the Neo-Marxian mythology, is weeded out, the more difficult it is to induce investors into foreign ventures and the greater is the dependence of exchange rates on the vagaries of the trade balance and of foreign exchange speculation.

Briefly, gold has turned from serving as the monetary base into being a prime monetary nuisance. The fact that private hoards absorb annually a large percentage, some years as high as 30 to 40 percent, of the new outpu of gold is a source of financial weakness, not only in Latin America and the Orient, but especially also in France and in the South European countr In France it is estimated that from 3.5 billion to 5 billion dollars are buried in private treasures.

The withdrawal of such huge liquid wealth from productive use must affect wealth creation and generate a psychological deterrent to economic progress. What is more, this hoarding propensity is a deterrent to the preparedness effort. Gold is still essential for the settlement of international balances. Its disappearance in "stockings" reduces the supply ar tends to raise the price of gold in terms of all currencies, including the dollar. That in turn has repercussions on foreign exchange and prime commodity markets.

Nor is that all. Since the bona fide capital stream between countrie both of short-term and of long-term character, has virtually dried up, the movement of gold has grown in dimension. But instead of this being a fac for stabilizing exchanges, and for bringing about international equilibri those gold movements produce a disequilibrating momentum. They follow the lead of the least productive of all economic motives--pure in-and-out spec lation. Each time a currency is under fire, gold runs out from under in a panicky fashion; each time a currency's position strengthens, gold rushes

The weakness of the pound in 1949 induced capital to run out of Engl and forced it into devaluation. The recent weakening of the balance of payment position of this country, due first to a new boom and then to the Korean "police action," drives it the other way--out of the dollar. This country has lost almost two billion dollars of gold in little more than a year, most of it in seven months' time. Simultaneously, the dollar price of the yellow metal in the free markets of the world is climbing. Gold coins again are selling in Paris, Tangier, Beirut and Hong Kong at the equivalent of $50 per ounce and better, against our official price of $35 an ounce. This irrational capital flight has raised the Uruguayan curren as an example, from a parity of three pesos to a dollar to a high of two one within a matter of a few months. Having acquired unlimited power ove its foreign exchange rates, and having broken the "rigidity" of the gold standard, the welfare state is incapable of securing exchange stability.

Uruguay is the principal outlet for flight capital today. The Swiss capitalists are shifting on a large scale from their holdings in dollars into holdings in Uruguayan pesos. Surely, Montevideo is not a safer plac than New York. The reason is that the Uruguayan peso is not to be devalu according to speculation, like the American dollar might be. As a matter of fact, Europe and Latin America expect an early devaluation of the doll If they expect it strongly enough, they might bring it about, because the might draw so much gold out of the U. S. that one or two things will happ But I am ahead of my own story.

Losing two billion dollars of gold in a short stretch, possibly the greatest single gold movement in any such period of history, proves that the international capital market is very much alive. A person with a high fever may be more alive than one with a normal temperature. Presently, the continued loss of gold, which the United States Treasury countenances, is being shrugged off by many of our administrators and experts as a healthy sign of a better world-wide distribution of gold. They say: "If we have 24 billion dollars, what does it matter if we lose 2 billion?"

The trouble is that it is not being better distributed by this process. It is adding little or nothing to the equilibrium of the recipients, while creating a threat to the dollar. Uruguay doesn't need that gold reserve. There, it constitutes largely hoards or causes inflation. On the other hand, confidence in the dollar is a <u>conditio sine qua non</u> for efficient mobilization. At both ends this gold flow fosters inflationary conditions or expectations and endangers the preparedness potential in more than one way.

The danger is far more serious in Europe than on this continent. For one thing, not all nations gain gold when we lose it. At the present time some of the greatest gainers are those which contribute least to the common military effort. Others lose, too, while the effect of their luckier neighbors' credit expansion on their own system is stimulating inflation. Even the gainers enjoy it with misgivings. The recent strengthening of the French monetary reserve by gold influx resulted in a proportionate rise of the French note circulation, which has inflationary effects.

Nor is this gold redistribution without drawbacks. It is due in ultimate analysis to a large extent, to the upsurge of American demand for foreign raw materials which skyrocket in price. The sterling area may profit from gold; but Britain's domestic equilibrium is on the verge of collapse due to the rising material prices which, coming on top of the devaluation of the pound and of extreme import restrictions against American products, call in turn for higher wages, unleashing the well-known price-wage-price spiral. Faster or slower, the same vicious circle is at work in France, Germany, Italy, the Scandinavian countries, and the Low Countries--everywhere.

In other words, our gold redistribution does not bring stability to the recipient countries. Even where gold redistribution could do good and is not used for pure hoarding, it helps to raise prices directly or indirectly and to unleash the price-wage spiral and endanger, nay, more then endanger, break down, the artifically held-up price structures.

What if the gold flow from this country continues further? The last statistics I have seen, those for the end of October, show that the United States hasn't lost a cent in terms of foreign capital investments in America. As a matter of fact, in the third quarter of 1950 we still gained capital from abroad. Evidently, what capital has gone out of this country--the foreign dollar balances that were converted into gold--outbalanced the dollar inflow by more than 2 billion dollars in a year's time!

What might happen if the some eight billion dollars statistically known liquid or short-term foreign holdings in this country start moving? What if American capital starts following the example, thinking that it is better to have rainy day reserves in Mexico and wait until the expected devaluation of the dollar is over? In short, a run on the dollar might develop if this so-called healthy redistribution of gold continues.

Under the bygone gold standard this gold flow would have brought about skyrocketing interest rates and falling commodity prices until our balance of payments position had been restored. That is the so-calle automatism of the gold standard. Presently, deflation, even of a mild sort, is taboo. The idea of full employment--meaning permanently stable or rising prices and wages--combined with the necessities for preparedness and with the frozen structure of our interest rates precludes the possibility of any such normal corrective. That is where the outer world's fear comes in. It anticipates one of two courses to stop the gold out flow: that the dollar will be either devalued or frozen. In either case the entire commercial system of the Western World will be thrown out of gear, and the expectation may set into motion new capital flows of hug dimensions.

How did we get into this unstable position? What makes an internati financial system work in such an unbalanced fashion? Without trying to write its history, let me point out the fundamentals of the post-World-Wa II international financial situation.

The fundamentals are of an ideological nature. They are embodied in the Bretton Woods program, or, rather, in Lord Keynes' idea of such a program. That project marked a new departure in monetary history. The two institutions, the International Fund and the International Bank for Reconstruction, and what they stand for, were a compromise, naturally; but the idea is clear. It was a combination of ultimate objectives of mutually excluding character.

On the one hand, the stability inherent in the old-fashioned gold standard was to be restored, but without the gold standard. This was to be accomplished by several sets of directives. All member currencies were to be attached to one another by being put on a dollar base, and the exchange rates fixed after a fashion. They were changeable by collective consent only, not by the arbitrary decision of any single government. Multiple currencies and what they entail--exchange restrictions, payment agreements, clearing agreements, barter agreements, and similar discriminatory tricks a la Schacht--were to be outlawed. The whole syste was to function with the aid of short-term credits from the international fund and reconstruction loans from the International Bank for Reconstruct the assumption being that the credits would serve merely to ignite the motor of genuine international capital flow.

On the other hand, each individual country was left to follow domestic policies as it saw fit. It was supposed to do so along the lines of the full employment ideal, propagated by such superplanning bodies as the U. N. Economic Commission. To permit inflating the currency at home and simultaneously stabilizing it abroad, escape clauses were inserted into the Bretton Woods program allowing for devaluations and exchange controls.

But the full employment policies to be pursued domestically and the stabilization to be obtained internationally simply were not compatible with each other. The Bretton Woods institutions soon turned out to be a failure in the sense that they could not possibly fulfill the impossible--to re-create the free capital markets and to normalize the balances of payments, that is, to play a game in which two sets of rules were applied, one annulling the other. The Fund and the Bank were left with the choice between throwing their substantial but limited resources into a bottomless barrel and going bankrupt, or else throwing in the sponge and leaving the solution of the insoluble problem to someone else.

That someone else was Uncle Sam, needless to say, who has been the promoter of the Bretton Woods program from the outset. Naturally, the job to make it work was his; and he tried to make it work by pouring out an annual six to seven billion dollars through the well-known channels of the Anglo-American loan, the Marshall Plan, Truman Doctrine, the Export-Import Bank credits, and so forth, with the result of maintaining artificially his inflated domestic price and wage level and weakening his own financial position without restoring that of Europe or Latin America to anywhere near a genuinely self-supporting condition.

Now, the erratic capital and gold movements that I am talking about are nothing but symptoms of discrepancies between the official price of gold in paper moneys and the value of gold or its purchasing power in terms of commodities. Our commodity prices rise, while the price of gold is fixed. That is a disparity which calls for correction in one way or another. How long we can stand the tension and how soon it will be corrected is a moot question. For most other countries the question is burning rather than moot, because it coincides with many more acute tensions.

The one common denominator of the outer world's economic and therefore psychological troubles more than any other, and the one that underlines the gold and capital movements in these erratic forms is inflation. Inflation is the prime reason for most countries' inability to withstand the strain, for being thrown off center at any major provocation. If partial mobilization puts the European nations under such a severe economic test--and, mark you, it is a severe economic test for all European countries, much more so than for us, even before it starts--it is so because of the inflationary pressures under which their economic bodies labor.

These pressures go a long way to explain the European public's reluctance to be drawn into a military preparedness. When virtually all budgets are in the red before the impact of armaments hits them, people who are overtaxed already, more so than they are in this country, are inclined to resist the invitation to pay still higher taxes and to incur still more deficits. That should be obvious.

The inflationary condition of the Western World, particularly in Europe, is evident on every score. It is the outcome of policies which were based on the Bretton Woods ideology, combined with an attempt to carry on self-sufficiency policies at home, to inflate at home, to maintain uneconomically high prices and wages at home, while at the same time trying to maintain international financial stability. It is a superbly grandiose conception--to make the best of both worlds of finance, to merg the monetary stability of the gold standard with the economic security of the managed paper money. But it is as unrealistic as to concoct an economic system by infusing socialistic over-all control and planning into a capitalistic body of competitive markets.

A game can be played rationally if its rules are clearly defined and if the players adhere to the rules. The Bretton Woods philosophy did not fulfill the first criterion, which made it simple for the players to violate the second. In any event, the system failed on every score. Genuine international lending and investing did not materialize on a worth-while scale. Instead of dying out, multiple currencies and monetar barbed wires strangulate the commercial and financial intercourse betweer nations. Instead of being stabilized, all but three or four currencies have been amputated once or several times since World War II; not a singl one is standing safely in its "golden slippers," with the possible exception of the gold-saturated Swiss franc.

The most spectacular aspect of this general unbalance is the fact that, notwithstanding all the American aid and all the European maneuver: the dollar shortage of the outer world first grew into a permanent calam: then turned almost overnight into a dollar surplus, with almost equally calamitous implications. Both stem from the same source, inflation; and both were treated with the same medicine, inflation.

Such generalizations risk neglecting many side issues and minor aspects. But the real issue is what we are interested in today. The common denominator of postwar economic policies outside the Russian sphere--I wish I had time to compare the western with the Russian financial system--is fostering inflation, but at the same time supressing its manifestations by excessive taxation, rigid controls, more or less futil international commodity and trade agreements, and so forth. Inflation i: self-adjusting, self-repairing phenomenon if it is left to the free mark to cure it. It runs its course and then it ends. But we maintain inflation permanently in the Western World by trying to cure it by repressive methods. It is like repressing a fever so that it cannot fully break out but stays with you for good.

These two types of policies--inflation on the one hand and all sorts of repressive measures to keep inflation from breaking out fully--add up to what has aptly been labeled a rigid society. I am speaking of Europe now. The term "rigid society" was coined to describe the absence of dynamic momentum--the defensive attitude, the lack of incentive and of adaptability, the bureaucratism and passivity of the mature economy--the qualities which are responsible for Europe's impotence in matching the American industrial progress.

Their most tangible expression is the inability of European industries by and large to compete with ours for the export outlets. In spite of very much lower wages everywhere--as much lower as one-third of American wages in Italy and in Germany--there is no country where the average of prices on manufactured products can be lowered to the United States level, not even when American know-how and machines are utilized, and not even after the currencies have been devalued. This apparent mystery baffles the efficiency experts, who think in terms of the stop watch rather than of initiative. The truth of the matter is that the European type of controlled or subdued inflation produces all the disadvantages and few of the temporary stimulating effects of inflation, because it eliminates much or most of the temporary profits and real wage increases--those benefits would be temporary anyway--and leaves everybody dissatisfied.

Since Korea, American exports, those for which payment is received, not counting the freely exported goods, are declining, while imports are skyrocketing. Did the Marshall Plan--which was but another attempt to fulfill the Bretton Woods promise--succeed in making Europe self-supporting? Nothing of the sort is indicated. Whatever else the Marshall Plan has accomplished, such as expanding productive facilities and raising living standards in the recipient countries, it certainly has fallen short of its main purpose.

Now, we are again on the threshold of a new departure in global finance. What we need is a psychological adaptation of our allies and the conversion of their physical plant to the requests of the new situation. However, we are faced with the heritage of postwar international finance. Our well-meant attempts to persuade and cajole our friends, such as by the European Payments Union and other alluring offers, into greater flexibility and self-reliance, have not been entirely futile, and the attitudes differ substantially from country to country. But, broadly speaking, there is no doubt that what we have financed is a process of economic freezing. Protected by bureaucratic setups, unionized and cartelized monopoly interests, their price structures and incomes tend to freeze into solidified aggregates. The billions spent on Europe, whatever their value from the humanitarian point of view, have failed in preparing the ground for the kind of mobility and flexibility that grows out of the free interplay of competitive incentives only.

We have relieved Europe of the implicit burden of capital accumulation, from the burden of saving at a sacrifice and investing under the guidance of the cold profit motive. The result is that a system so deeply feeble emerges that its price structure can be kept together only by extremely careful navigation between the cliffs of shaky price-wage system and conflicting vested interests and rights. Monetary injections do not work any longer, because they have gone so far that any greater doses are likely to create runaway conditions. Taxes cannot be raised, because they have reached the limit. As a matter of fact, they are so high that they must be shifted on the consumer, that is, on the working masses, whose rea income is deficient accordingly. Direct controls do not work, because the people's patience has been exhausted too. They merely emphasize the empti ness of a monetary unit that is based on promises by which people do not live.

If international finance of the postwar years, looking at it from the preparedness angle, is a dismal picture, it is not because one or the other group of politicians or administrators is not worth its salt (which may be the case, incidentally, too). It is because it was a totally misguided system from the outset. The problem of our international preparedness policy, its prime financial problem now, is extremely difficult. How can you induce a Frenchman or a Britisher to raise his unit productivity, to be concrete about it, or to work longer than six days a week and eight hours a day, unless at substantially higher wages, and therefore at runawa costs, after having made it financially possible to imbue him with the philosophy that such overwork is contrary to the laws of ethics and econom How can you make an apparatus of production convert itself in a hurry afte its entrepreneurial spirit has been congealed into monopolistic security-seeking, emasculated by petty bureaucratism, and diverted into tax evasion as its chief preoccupation? And do believe me, I am not exaggerating.

I have painted a very dismal picture indeed. Contrary to my habit, I have read a major part of this talk; and perhaps I was galloping too fast to be understandable. But the last question is: What can we do about it now? It looks like a hopeless situation.

Fortunately, it isn't so hopeless as it looks. The fortunate thing about the capitalistic system---I don't know what I should compare it to---that it can be hit very hard and stand up promptly again if given a chance. The profit motive is so strong that it can't be killed. It can be hurt but it restores itself overnight if given a chance to restore itself.

The problem is to restore the profit motive. By "profit motive" I mean profits in the broad sense, that in which it is everyone's motive to make a good living. The problem is to restore that motive by giving it sufficient freedom and at the same time to channelize it in the proper direction. It is a very difficult problem politically and economically, but it can be solved.

It presupposes very close financial and economic cooperation on the highest level. We will not get very far, I dare to predict, with mobilizing Europe into preparedness by military cooperation alone, as basic and fundamental as that, of course, is. We are not rich enough, to put it in popular terms, to provide 250 or 260 million Europeans with all the means of warfare. They obviously have to do it themselves to a major extent. They have to do it along lines in which they must cooperate with us or we with them.

Now, this is perhaps not the place, and certainly it is not the time, to try to elaborate a program of how to go at that. It is burdened with the most difficult diplomatic, political, and psychological issues. We have to overcome vested interests, political and economic, political in particular. We have to overcome prejudices, fixed ideas, and biases of all sorts. The American statesman who will manage to accomplish that will have done something really great. It is a job far more difficult than that of the logistician or the military side alone.

The possibilities are vast and they don't need to be accomplished to the full extent to be effective. Steps can be taken in the right direction, with the right methods, and we can make progress. But let us be prepared for what is a major probability--that it will be a very slow progress, much slower than the military calculation itself from the purely military angle would expect it to be.

It will be a very slow process to make Europeans be efficient, that is, to overcome the manpower shortage, for one thing, with which they are already faced now and will be faced to a rising extent. It presupposes a much greater efficiency in their utilization of manpower, the basic resource. That will be the number one problem. To do that is to put your finger on something against all the vested ideological and political and economic interests which are freezing the labor position in Europe. It will be difficult in this country too, but far more difficult in Europe.

Therefore let us count on a very slow process at best. At its worst I wouldn't like even to consider it. The necessities of the situation are such that I take it for granted that on both sides of the Atlantic the men will rise who will be competent and powerful enough to put over the most unpleasant and undesirable reforms, such as reforming the European manpower setup.

COLONEL BARNES: We are ready for questions.

QUESTION: I am not sure that I understood part of your speech. I want to rephrase it and see if I did. As I understand your statement, it was that the Marshall Plan has failed in its main objective, that objective being to make the countries of western Europe self-supporting. From the statistics, what little I know about them, it seems to me that France, for example, is producing more steel, coal, and so forth than it was, let us say, in 1938. To a limited extent that may be true of England also, and Germany is nearly up to where it was. If what I understood about that is correct, I have difficulty reconciling your statement with it.

DR. PALYI: That is a very good point. There comes in the great distinction between production and finance. One may produce at a record rate and go bankrupt if one produces the wrong thing.

Statistics of production per se don't mean much. The British show a production volume some 30 percent above the prewar level, but that includes the services of waiters in restaurants; and there are many more waiters today in England than there were in 1913. Nor does it help even if they produce more steel, as is the case in England, if they don't produce enough coal, as is also the case in England.

In France, production has obviously increased. But what happened there? In the first place, the exports to the dollar countries did not increase as imports from the dollar countries did. What does that mean? It means the same thing in effect as the difference between being in the red or in the black. It is just a tiny difference in color, yet it means a lot.

Let me cite one more example. A railroad can run perfectly while in bankruptcy, with a trustee running it; but it is still bankrupt. From the point of view of production, that is, the railroad's output in freigh service, there is no difference; but you will sense that there is somethi in the picture that is not desirable and that in the long run has an adve effect on the whole enterprise.

That is the situation in Europe. The French cannot balance their income and outgo without continued Marshall Plan aid, even at this nonmobilized time. That aid is just a small item, just a few hundred million dollars, half a billion dollars a year. But somebody has to put up those dollars.

If we are so rich here that it makes no difference to us whether we pay the French every year a half billion dollars, well, that is one way of looking at it. That is the way French are beginning to think about it. But that is not a healthy way to look at it in any sense of the word "healthy." It is likely to have unhealthy consequences.

Suppose we do not continue to give France a half billion dollars a year. What happens if America should labor under such strains that half a billion dollars to France every year and a half a billion to someone else and so on mean that prices are skyrocketing and that therefore we revert to the old-fashioned idea that we must cut down on the bonuses to foreign countries. That is a very old-fashioned, gold-standard sort of idea. It is out of currency now, but it might re-emerge. What then will happen to the French system? It will be faced with a crisis. Their expanded steel production stops, because they don't get the raw material with which to produce steel and so on.

In other words, what matters is not the production volume. One must look at the economic process under the long-term point of view. Germany had the most prosperous era in its history during the twenties, which I had witnessed very closely. At that time Germany was putting up plant after plant, all on borrowed money. The money was borrowed at 7 percent average interest rate. The result was an unreasonable overexpansion, especially so in proportion to the export possibilities. Germany got stuck on it and an international crisis developed.

The lesson should be obvious. If one carries industrial expansion beyond balance with the prospective outlets and at prices at which those outlets can absorb the products, a point will be reached at which production stops. The productive facilities will become to a large part worthless, because they cannot be used, there being no market for the product, unless one resorts to a Russian type of system in which there is no such thing as a market problem. In that system the government provides the outlets by adjusting them to the existing facilities. But even there errors occur and plants may come to a standstill even though to a very limited extent compared to ours.

In other words, if we want a free economic system, which is the counterpart of a free political system, we have to think in terms of future markets. There is only one way to plan for that, and that is by way of the price system, by watching prices and adjusting production to what prices indicate should be produced.

But that so-called price mechanism has been almost eliminated in Europe, or its operation vitiated. Production of capital goods, in particular, is based on government planning without any regard to the prices involved. Whether it is profitable or not at given prices, makes no difference. Which is exactly like in Russia, but with this difference: That in western Europe there is no Russian system in which one can force up the sale of those products. Thus an unbalance is bound to arise.

Actually it has arisen. The unbalance between domestic production and exports has become a permanent feature of the European industrial apparatus.

Why that unbalance? Because the Marshall Plan makes possible domesti production without putting on pressure to adjust the export demand. If we had given the Marshall Plan money on terms which would have forced the Europeans to use it for expanding exports proportionately with the increas in production facilities and with the rising level of living standards that would be another story.

That would have meant for ECA to take over the management of the European economy, while the basic principle of ECA is that we don't mix into the domestic affairs of each individual country. Otherwise, they might get offended and might not even take the money from us.

QUESTION: I was wondering what the repercussion would be if instead of devaluing the dollar, we raised its value. What would happen then?

DR. PALYI: If we raised the value of the dollar, that is, if we should declare, say, that an ounce of gold is not equivalent to 35 dollar but only to 17.5 dollars, then, of course, all those who quit the dollar would be in a very odd position. They sold it at a time when the dollar was low in terms of gold and will have to repurchase when it is high against gold. The speculators would have burned fingers or their pocket-books; and they would think it over a long time before they speculated that way again. So far so good.

But what does raising the gold content of the dollar imply? It implies that the gold reserve of the Treasury is worth that much less dollars. If you double the gold content of each dollar, and gold reserve is 22 billion dollars, it would then be worth only 11 billion.

Who takes the loss? From what source do we write it off? It is a writing-off, a bookkeeping operation, if you please; but the books must be in order. We will have to raise additional taxes to the tune of 11 billion dollars or a loan in that amount.

Moreover, another question arises. Suppose the American balance of payments stays adverse, that is, imports exceed exports, which is what causes speculation. Well, it will take much less gold outflow to ruin the gold basis of the dollar than it did before. In other words, unless you cure the underlying forces that tend to unbalance the American balanc of payments, the same situation would arise sooner or later again. For t time being, we would have won a victory over the speculators.

But how long would that last since the trouble is not cured? The underlying trouble could be cured only if we used revaluation as an opportunity to reduce the money volume. But that would be deflation. Just imagine what would happen to the stock market, to inventory values, to wages and civilian employment, and so on. A collapse would occur. I would like to see the politician who dares, to consider such a move.

COLONEL BARNES: Dr. Palyi, we are very grateful for your coming down here. It was a very stimulating lecture, very interesting. Thank you very much.

(12 Mar 1951--650)S.