'The bankruptcy of the monetary system', from Le Monde (25 September 1971)

Caption: On 25 September 1971, the French daily newspaper Le Monde reviews the impact of the decision taken six weeks earlier by the US President, Richard Nixon, to suspend the convertibility of the dollar in the light of economic policy.

Source: Le Monde. dir. de publ. Fauvet, Jacques. 25.09.1971, n° 8 304. Paris: Le Monde. "La faillite du système monétaire", auteur:Paul Fabra , p. 14.

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The bankruptcy of the monetary system

I. — The ‘law of supply and demand’

By Paul Fabra

If we are to believe Mr Karl Schiller and the proponents of floating exchange rates, giving free rein to market forces is the surest way to establish the true value of currencies. Let the central banks stop intervening, they say, and the much-vaunted law of supply and demand will come up trumps. This theory is poised to win the acceptance not only of many economists but also of numerous Western politicians and leaders. According to its proponents, any procedure which establishes more flexible exchange rates would constitute an indispensable component of any reform of the monetary system.

The main reason why flexibility has such great appeal is undoubtedly that it seems to be based on irrefutable logic. It enables all of the Western countries to rely on the market to fix prices for the bulk of goods and services. This method has not given them too many grounds for complaint.

If the market is as efficient as it is claimed to be, is it not paradoxical to exclude such an important element as currency from its scope? Does this not mean those who advocate fixed exchange rates, while expressing support for free trade in goods, capital and services, are irremediably at odds with themselves?

Even reputable thinkers on the Left, not to mention the German Social Democrats, have been succumbing to this argument, and floating exchange rates are enjoying a good press among most young professors and lecturers in political economics, whereas fixed parities are sullied by the tarnished reputation of the precious metal on which their valuation is based. Many people seem to consider it difficult to acknowledge a need to respect the law of supply and demand; nevertheless, experience in both West and East has so often shown that ignoring it can result in bitter disappointment, that it is better, when all is said and done, to go along with the law of supply and demand, even if its impact has to be cushioned by means of an appropriate social policy. It remains to be established whether this much-vaunted law actually exists.

We have to agree first of all on the definition of the word ‘law’. When Isaac Newton was hit on the head by the famous apple, his contribution to science did not consist in discovering the ‘law’ that a fruit, having become detached from its tree, plummets irresistibly earthward; that is a matter of experience. Mankind has remembered the name of Newton because he discovered that the everyday accident that he had just suffered was governed by the universal law of gravity.

If there is a strong demand in the market for a particular commodity, such as tomatoes, flowers or deutschmarks, the supply of which cannot be immediately increased, it is self-evident that the price of the commodity will rise. We do not need an economist to teach us that. The contribution of the political economists began when they were able to demonstrate that, beyond any price rise triggered by an increase in demand and a temporary shortage of supply or, conversely, any fall in prices caused by excess supply and insufficient demand, there is also a *regulatory principle*, whereby prices in a market in which competition is not too imperfect will be drawn inexorably into the magnetic field around production costs, as if they, too, were subject to a law of gravity.

We are not indulging in quotation for its own sake if we recall the words written at the dawn of the nineteenth century by the economist who is still regarded today as the greatest theoretician of free trade: ‘The opinion that the price of commodities depends solely on the proportion of supply to demand, or demand to supply, has become almost an axiom in political economy and has been the source of much error in that science’ (David Ricardo, *On the Principles of Political Economy and Taxation*, Chapter 30, entitled ‘On the Influence of Demand and Supply on Prices’).

To ascribe the status of a ‘law’ to the action of supply and demand is to forget that it cannot be *regulated* unless certain very specific conditions are met within the market. For example, wherever demand cannot generate an increase in supply, even after a time lag, we are faced with a disorder that the market cannot do

anything to rectify. This is the case, for instance, whenever there is heavy demand for plots of land close to a town or city.

So unless we distort the meaning of the word ‘law’, we cannot apply it to anything but existing regulatory mechanisms. Otherwise the expression should only be used in political economy in the sense assigned to it in the underworld, because there is certainly a ‘law’ governing black markets, in so far as a shortage of goods enables the seller to dictate to the buyer. This is not to deny the key role that is played in a competitive or virtually competitive market by the interaction of supply and demand; this interaction, however, must not be seen as the law itself but as the instrument through which the regulatory element, namely the cost of production (including the normal profit margin), will ultimately determine the ‘market price’ more or less peremptorily.

It is not difficult to understand why the ‘axiom’ which exponents of the budding science of political economy denounced as erroneous went on to enjoy such great success. The elimination of one ‘objective’ constraint after another has created a world that is increasingly devoted to the pursuit of arbitrary aims, in which the ‘law’ of supply and demand is actually synonymous with the supremacy of desire, of a more or less artificially stimulated ‘need’ — in short, of psychology.

Only a decade of the Bretton Woods system

This deregulation could not work unless the instrument used to measure *value* was itself freed, as it were, from any reference to an objective basis, an aim that can always be achieved in a situation in which it is fairly easy for a central bank to issue money.

History, however, will show that, at the Bretton Woods conference in 1944, the Allies wanted to restore, for the post-war period, an exchange-rate system built on the two basic principles underlying the system of the gold standard, which the world had more or less abandoned after the acute economic and monetary crisis of 1930. The two principles were fixed parities and free convertibility between currencies, and the common standard to which currencies would be pegged was the dollar, the only currency that was strong enough in 1944 to be made convertible into gold.

It is commonly written that the Bretton Woods system which has just collapsed lasted for 25 years. This is inaccurate; it was not properly put into effect until the end of 1958, when the European currencies became convertible in their turn. Its death throes began in November 1967 with the devaluation of sterling and the ensuing turmoil — the abolition of the pool of gold reserves and the gradual dismantling, through the devaluation of the French franc, the first revaluation of the deutschmark, etc., of the pillar of stability formed by the six national economies of the European Common Market.

The keystone of the whole system was the free convertibility of the dollar into gold. From 1960 to 1968, during the whole period when the pool of gold reserves was in operation, Western governments moved even further in the direction of a restoration of the gold standard than had been intended. During that period, all the major currencies were convertible into gold *at a fixed rate* on the free market; the dollar, for its part, could also be directly converted by the central banks through the US Treasury. It is no coincidence that this period was also the heyday of international trade.

In actual fact, the ‘restoration’ of the gold standard was more apparent than real, for a reason more subtle than was publicly admitted. It has often been noted that the dollar remained convertible because the United States’ creditors had agreed, under pressure from Washington, not to exercise their right of conversion at all or to practise extreme moderation if they ever did exercise it. This is true, but, to explain the pre-eminence of the dollar in relation to precious metal, we must add that the issuing of money in the United States has long since ceased to depend on the quantities of gold entering and leaving the country. Not for a long time has the dollar been defined in terms of gold; on the contrary, gold is now defined in dollars.

As has already been emphasised by Sir Dennis Robertson, a very remarkable economist of the period following the First World War, whose most notable publication is a little book of great significance, entitled

quite simply *Money*, the nature of a monetary system is not ultimately determined by abstract statutes or models but by the balance of political and economic forces in the real world. The system under which we operate today is not based on the dollar standard, on what Robertson called the system of an arbitrary standard, because the value of the dollar is merely the expression of the way it is administered by those in whose care it has been placed.

The power of governments to influence events, however, is not absolute. An excessively rapid fall in the value of the dollar creates its own momentum in the form of a flight from the depreciating dollar, requiring a President of the United States, in the middle of summer, to sever the remaining links between the dollar and gold, which, though undoubtedly more symbolic than real, were not entirely insignificant, as has been shown by the upheaval following Mr Nixon's decision to 'suspend' convertibility.

Since then, the 'law' of supply and demand has therefore reigned supreme in the currency markets, and it might be feared that this will cause disruption, if not chaos. Let us not be unduly surprised, for any reasonably careful consideration of the arguments advanced by the proponents of floating exchange rates raise extremely serious doubts about the validity of the solution they recommend.

The main advantage of flexible exchange rates, if we believe the advocates thereof, is that they enable governments to pursue autonomous economic and monetary policies while their countries continue to enjoy freely convertible currencies and free trade with other countries. At first sight, one cannot but commend this view. Is not the main objection to fixed exchange rates that they considerably restrict a country's room for manoeuvre?

The League of Nations 1944 publication *International Currency Experience,* a work crammed with information which recounts in great detail the monetary events of the inter-war period, adding its own analytical observations, defines the gold standard *and, in fact, any stable system of exchange rates* as a system in which the volume of each country's money supply is primarily determined by the balance of payments. Who would not prefer floating exchange rates to such a rigid system? Surely what really matters in our day and age is that each country should be able first and foremost to achieve the main aims of its domestic policies, beginning with full employment.

The novice skier and political economy

The answer to that is that political economy is a little like swimming or skiing. If those in charge of the economy try to achieve the goals they have set themselves by taking what seem to them to be the most appropriate measures in the circumstances, they are very liable to find themselves in the position of a novice skier whose instinct tells him to execute the very manoeuvres he must avoid. Since the war, the countries that have laid emphasis on full employment have not been the most successful in achieving it. The United Kingdom and the United States, for all their long-standing attachment to Keynesian policies, have experienced uninterrupted unemployment, while Germany and Switzerland, where concern for the balance of payments has been absolutely paramount, have maintained almost constant full employment.

Another objection relates to the international *balance* itself. Every time a country's exchange rate is altered, whether by government intervention or market forces, the impact of the adjustment is felt more or less keenly in the economies of other countries. When the value of a country's currency depreciates, its industrial and agricultural products can compete more easily with those of other nations; if, on the other hand, a currency appreciates in value, it can happen, as in Germany at the present time, that the country with the strong currency offers new export markets to foreign countries which would be better off without them, because their economies are already overheating.

By letting its currency 'float', a country is actually freer to pursue the policy of its choice, but, by so doing, *it limits the freedom of others*. If every country acted in this way, it is difficult to see how any sort of international order could be maintained in the long run. The risks must not be taken lightly, given that the strong aversion of all the major central banks to the idea of accumulating more dollars threatens to sink the Gold Exchange Standard.

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