

Rugina, Anghel N.

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Stabilisation through Monetary Reforms

by Professor Anghel N. Rugina, Boston *

For many years, there was and still is a discussion about a European monetary and financial system and consequently a European Central Banks Union. But all these proposals are still on the drafting board. Here a plan is presented which gives a hint why a European Central Bank is hard to establish under the existing conditions and even if established, it may encounter insurmountable difficulties to achieve a normal functioning¹.

The plan must in no way be interpreted as a recommendation for application of a project which would take France out of the European Community Market. It should be viewed rather as an exercise in thinking about the model of conceptual analysis and policy application on what can and, as a matter of fact, should be done in every member country of the European Community.

The end purpose is to minimize the possible conflict of interest among the old and new members of the European Community and at the same time to increase significantly the degree of financial stability and social justice in the distribution of income, two major goals which now seem to be a part of the calling of our time.

The Basic Problem

With a paper-credit-fiat money system tailored in each of the various countries in Europe to satisfy financial needs of the government, no European Central Banks Union could ever work to bring positive fruits and no evil consequences. This is the new message of this plan. The reasons are simple but of basic nature.

□ First, any form of paper-credit-fiat money is inherently unstable and cannot be controlled in

the manner and extent to achieve a stable equilibrium supply of money.

□ Secondly, the same type of money through its nature and functioning sharpens the social question, again in the form of a paradox, that is increasing abnormal inequalities in the distribution of income at the same time when production is rising. This phenomenon could be observed here in the United States after World War II but I think also in West Germany, France and other countries with booming economies and a paper-credit money system. The Federal Reserve System in America which is a sort of American Central Banks Union, under ideal political conditions (that in Europe do not exist yet!) failed to secure a financial system with no inflations or sharpening of the social question.

In view of recent financial difficulties encountered by the French economy, a plan is presented here for its immediate stabilisation in the short, as well as in the long run.

□ Major task No. 1 is to drain the existing inflation and to create conditions of stable equilibrium in order to achieve a normal rate of steady economic growth with full employment. The basic difficulties of today do not stem from the economy as such, but rather from the financial and monetary system, which are too loose and unstable.

□ Major task No. 2 is to bring the internal value of the French Franc as close as possible to its external value and thus create conditions of stable equilibrium also in the balance of international payments.

Recommended Tools

Capital flight or flight from the French Franc and the inevitable loss of gold and convertible foreign exchange would stop automatically because the reasons for it would disappear. Indeed the troubles of today occur not because the French economy cannot export enough, but rather again because the monetary standard unit and the financial system are too weak in the sense that they do not respond quickly; they do not co-operate fully to make the mechanism of the

* Professor of Economics and Finance at Northeastern University in Boston, Massachusetts, and also from 1965-1970 Chairman of the Board of Economic Advisors to the Governor of the Commonwealth of Massachusetts, Boston.

¹ The author of this plan was among the original contributors to the French monetary and fiscal reform of 1959 with the proposal for a new, heavier Franc. An abbreviated version of the proposal has been published in the *Revue d'Economie Politique*, Paris, No. 2, Mars-Avril 1959, under the title: *Un Plan de Stabilisation Economique, Financière et Sociale de la France. Liberalisme Social*. He would like to dedicate this article to the memory of Professor René Courtaïn, Paris, former Chief Editor of the *Revue d'Economie Politique*, who understood that contemporary economics need a new, monetary orientation.

balance of international payments work. Instead of stable equilibrium, a recurring gap develops between the internal and external value of the Franc and that is at the core of all the troubles in regard to the international aspect of the problem.

The tools recommended for the realisation of the two mentioned goals are not of the common sort of more government controls and regulations but rather of a new type, consisting first, of a monetary surgical operation to remove the existing tumor of inflation, and second, of some changes in the framework of the financial system with the purpose of forging a few basic self-regulating mechanisms which in turn would provide conditions for stable equilibrium and full employment regarding both the domestic economy and the balance of international payments.

In order to drain the existing inflation there is a need for the introduction of a "Recent New Franc" (RNF) equal, for example, to 2 or 4 old New Francs, depending upon the actual proportion between the total supply of money and the aggregate amount of gold and convertible foreign exchange available at the time of the reform. This is the surgical operation for an instantaneous cleaning of the present inflation.

To avoid further difficulties for the French economy, all prices, incomes and claims (private and public debts, taxation included) have to be reduced by the same ratio as the money supply is decreased through the introduction of the RNF. To avoid further difficulties in the balance of international payments, the present foreign exchange rates and foreign claims must be reduced by the same ratio, when expressed in RNF.

Functioning Credit Markets

One of the primary reasons for financial instability in France—as in other free countries—is that the boundary line between money- and capital-markets has been lost almost completely, and thus a continuous shifting of funds from one market into the other—usually at the wrong time—is creating an ever recurring disequilibrium. For the same reason, the interest rates on both markets are diluted beyond recognition, and appear artificially lower or higher than under normal conditions.

The money market, in accordance with its nature, has to provide and preserve a normal degree of liquidity in the economy measured by that amount of immediately available funds which have to suffice so that the economy may carry on the production, distribution and exchange of finished goods and services, necessary to cover current needs. The capital market (savings and issuance of

securities), again by its nature, has to collect the amount of capital for new investments in the production of capital goods, that is to say, an indirect way to provide and improve the supply of goods and services for future needs.

The two basic functions of the two markets: liquidity and capital formation are as clear and different as day and night. "Liquidity" refers to financial stability of current needs and transactions, whereas "capital formation" is concerned with future production and needs. Thus the two markets have to be completely separated if we want each one to fulfill its proper function. Today, and often for purely speculative reasons, large amounts of funds in the aggregate may move from the money market into the capital market and vice versa, in this way creating artificial conditions of disequilibrium in both markets.

Liquid-funds Reserves

In order to restore equilibrium conditions in the money market, banks (private and public) which are in the business of receiving liquid funds in their trust as demand deposits, should be required by law to hold their checking- and current-accounts covered 100 p.c. in official money at all times. The supply of money will not shrink through such a reform since the holders of checking and current accounts could have their money back any time they want cash or can use it by drawing checks or sending payment orders. What this reform does is to stop private and public banks from creating and destroying purchasing power every day because this phenomenon is harmful to the economy as a whole.

A 100 p.c. liquid banking system is the best guarantee for financial stability with no runs on the banks possible and with a sufficient amount of liquid funds in the aggregate so that the economy may run smoothly with no booms or depressions. The funds used as required reserves are not idle or unproductive, but on the contrary they are active in fulfilling the important function of liquidity and financial stability. At the same time the amount of pure speculations on the securities market would be reduced to a minimum. In addition, the concentration of economic and financial power which may result in monopolies is also automatically restricted. Banks in general will do business within the existing supply of money provided by the Central Bank, respectively Bank of France.

Once a 100 p.c. liquid banking system has been reached, the phenomenon of monetisation of debt (private and public), in fact, the main source of inflation will also have been stopped. And with no danger of inflation in sight the credit-system of a

modern economy like that of France can develop to the maximum for the benefit of all concerned. The amount of credit generated and used in the economy will not come into the banking system, in other words, will not be monetised as it is today and, therefore, will not change the supply of money in circulation.

Gold Standard and ...

The issuance of official money will be entrusted exclusively to the Bank of France. It will be composed of a "Standard French Franc" and a "Commercial or Commodity-Reserve Franc". Actually, it is one and the same French Franc but expressed in two different ways. In both cases it is 100 p.c. covered except that the "Standard Franc" is backed by gold and the "Commercial Franc" is backed by a special commodity selected and warehoused in each of the 5 or 6 Monetary Reserve Districts. France will be divided into 5 or 6 Monetary Districts, and in each one besides gold a suitable, and in the district, most available commodity will be accepted as backing for issuance of money. Notes of the Bank of France could be issued in both cases, but clearly identifying those convertible in gold and those convertible in other commodities. As the official standard of value, only the gold-Franc will be used. The commodity-reserve Franc will be expressed in terms of the gold-Franc. Through a skillful handling of warehousing expenses, the Bank of France will try to keep the commodity-reserve Franc at parity with the standard Franc, a task which is less hasardous than what the French Central Bank is supposed to do today.

... Commodity-reserve System

The first novelty is that France would be the first modern country to have a 100 p.c. Gold Standard with a Standard Franc declared convertible in gold both at home and in the international markets. The second novelty is the addition of a 100 p.c. commodity-reserve money system with a commercial Franc convertible in a specific commodity traded on both domestic and international markets. This additional element has been introduced for two reasons in particular: first, to increase the flexibility of a pure gold standard and thus avoid the often expressed distrust by professional economists in this monetary system; second, to have an additional source of economic activity, real income and employment and thus satisfy the goal of full employment.

As mentioned before, France would be divided into 5 or 6 Monetary Districts with a principal Agency of the Bank of France. This Agency would accept for monetary purposes gold and one

specific commodity such as grain, lumber, wine or whatever is a major product of the respective District. In this way, each District would receive not only a certain degree of monetary independence (decentralisation of the issue of money), but also an important source of additional economic activity, real income and employment.

There will be a problem for the Bank of France of how to preserve parity between the two kinds of Francs, but it is not an impossible task. The other problem concerning the administration of the warehouses and the specifications for standardisation of the selected commodities lies in the domain of commercial business. It should be added that the accumulation of selected commodities in the various monetary districts actually represents an accumulation of real capital (like inventories) which can be used any time there is an extra need for it.

The Gold Price Issue

The unconditional convertibility of the French Franc (Standard and Commercial Franc) both at home and abroad, and the other changes in the framework of the financial system (money- and capital markets) would automatically create conditions of stable equilibrium in the balance of international payments. Indeed, when the internal value of the Franc will be equal to its external value, there would be no opportunity for a flight from the French Franc as in recent times and for capital evasion.

The price of gold is a more difficult issue and it would be handled in two ways: first, the price of gold expressed in heavier "Recent New Francs" could be reduced in the same proportion as the foreign exchange rates, that is by 2 or 4 depending upon the ratio adopted under point 1. This procedure would not create any problem except that France has to accept a nominal (on paper) decrease in the official value of its gold stock. Second, the price of gold could be maintained at the same amount as today, but expressed in Recent New Francs. This would mean a substantial increase in the value of gold, since the official gold reserves would remain the same, even though expressed in heavier RNF. What would be the effects of such an operation? France would pay all its current deficit in the balance of payments as well as those who want to convert Francs into gold (mostly for speculative purposes) by using only one half or one quarter of the quantity of gold which would be required in following the first procedure.

In regard to the second procedure, the question could be raised whether or not the foreign creditors and the speculators who want to con-

vert Francs into gold would not be defrauded, since their claims were reduced by 2 or 4 as mentioned further above. The answer is no, because the foreign creditors and the holders of Francs now would have an alternative, namely, to accept either gold or domestic securities or other forms of investment. The real value of the alternatives is the same after the internal value of the Franc equals its external value.

In following the second procedure, however, another problem arises. If the price of gold remains the same in Recent New Francs and no other arrangements are made, then the producers and hoarders of gold would rush to the Bank of France to convert that precious metal into more valuable RNF and reap huge windfall profits. In order to neutralise such unearned profits, a special gold-equalisation tax as high as 90 p.c. must be introduced and retained from any gold which might be presented for monetary purposes at the Bank of France after D-day. This tax, however, may also be handled in the long run in such a way as to encourage the production or import of gold if more gold reserves for international liquidity are desired.

Realisation Chances

France, being a member of the International Monetary Fund, has to consult this international organisation for any planned change in the for-

eign exchange rates and the price of gold. In the case of devaluation, the problem is rather difficult because the creditors have to face a loss or be forced to devalue. This plan proposes a revaluation of the French Franc with the result that its internal value would be at parity with its external value. Therefore, the foreign creditors would not experience any real loss.

If the other member countries of the IMF would agree to perform the same kind of reform, then there would be no change in the existing foreign exchange rates and consequently no problem whatsoever. Should they also agree to follow the second procedure, then automatically the value of the existing international liquidity reserves in gold would increase by 2 or 4 times, depending upon the ratio used, and again with absolutely no additional problems.

The realisation of this plan requires further that the Bank of France be separated from the public budget and the national debt. The French Government has to agree that its financial resources be restricted to taxes and public loans. In this way a balanced budget of the Government would introduce financial stability also in the public sector. The major functions of the Bank of France after the new reform would be to issue official money (100 p.c. covered) and to take all necessary measures for the stability of the French Franc both at home and in the international markets.

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PORTFOLIO-KAPITALEXPORT UND ZAHLUNGSBILANZ

(Portfolio Capital Export and Balance of Payments)

by Hans-Eckart Scharrer

The most important German capital export during the last years is welcomed by the Federal Government last but not least for balance of payments considerations. The present study makes a comprehensive contribution to quantifying the effects, whose influences on the creditor countries' balance of payments originate from the international security business. After a critical presentation of the traditional analytical approach, the net effects of non-recurring transactions as well as of investment flows, depending on the type of transaction and the attitude of debtor countries towards the creation of reserves, are deduced.

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