21 April 1954

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Professor Benj. Graham,
122 East 42nd Street,
New York 17, N.Y.

Dear Professor Graham,

Please, find enclosed the promised article. I may leave it entirely to you what use to make of it.

Yours very sincerely,

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International Price Stabilization

Instability of prices has been the form in which many have experienced the problems - sometimes disastrous to them - of economic instability generally, of the ups and downs of economic life. Price rises have brought them exceptional prosperity, be it mostly for a short time, price falls have sometimes completely destructed their existence. The many of which this is particularly true are the producers of raw materials, agricultural before all, sometimes also of mineral raw materials. Many of these producers have very modest incomes; and there are millions and millions of them, spread all over the world. Moderate price movements in finished goods are transmitted in ever larger amplitude to the sectors more "down" in the process of production, those of semi-finished goods, and of raw materials. The thirties are the most conspicuous years in which such a price fall occurred, bringing down the incomes of farmers to one-half or one-third of what they were before. There are other periods as well, however, and in a way every depression has shown similar tendencies. In addition there have been isolated movements for separate crops, such as coffee or rubber.

It is self-evident that the question has occupied many, can we do away with these harmful price fluctuations ? What are their causes, and can we expect to be successful in actions to change those causes ? It is an old reply by economists that there are causes "on the side of money" and "on the side of commodities"; meaning that partly the expansions and contractions in monetary circulation, in the hands of governments and the banking system, have caused price fluctuations to occur, and partly changes in physical production, before all crop fluctuations. Although it seems improbable that in the short run much can be done about these crop fluctuations it is possible, by stocking and destocking, to restrict their influence on prices considerably. This is even the oldest, well-known, example, described in the Bible.

The two groups of causes are clearly distinct; one may work without the other; although, on the other hand, changes in crops may also entail changes in the supply of money by banks. Accordingly, two approaches have been made to damp down price movements. On the one hand there are the proposals known as employment policy, or business cycle stabilization, mostly thought of as primarily financial measures tending to spend more public money in in dull times and to spend less in times of boom. On the other hand there are a long series of proposals, and of action taken, in the field of stock piling of commodities in abundant supply.

In the first group proposals have been more frequent than actual policies. Some attempts at applying them have been made, but rather scattered and often mixed up with measures of doubtful use. Anti-depression policies of the thirties are well-known examples; it is well-known that they came too late and were combined with unnecessary devaluations and with superfluous direct interventions in production and pricing. Nevertheless there is concensus of opinion, at the present time, that in the event of a new depression something of a compensatory budget policy should be followed by all governments, preferably in concerted action.

In the second group of measures some conspicuous successes, as well as various failures have been recorded. Successful market regulations were performed in tin, tea and sugar in the thirties, as well as in wheat during the last few years; and others could be added. The failures have been analysed and some of them were obviously due to imperfect schemes: schemes either too restricted in geographical area covered or as to the number of coherent markets included. No success is possible if one of a few interrelated markets only is subject of stocking or production regulation. Evidently a major further factor making for failure has been the acceptance of too ambitious price levels as their targets.

What is perhaps the most unsatisfactory feature in the whole situation about price stabilisation is that the problem has hardly been recognised to be a general and not a specific problem; i.e. a problem for all markets together rather than for certain specific markets. It is true that certain writers very clearly emphasized this side of the problem already long ago; but practical policy has been peacemeal all the time and not up to the standard required by the real nature of the problem.

It was a wise decision therefore that the Secretary-General of the United Nations charged a committee of experts with the task to report on the problem of price stability of primary commodities. More precisely the committee were asked to prepare during 1953, a report on such practical measures as it may be advisable to adopt pursuant to certain recommendations formulated by the General Assembly of the U.N. in 1952. These recommendations were based on the desire not to disturb the economic development of raw material producing countries by sudden changes in their terms of trade.

The committee consisted of Professor Carter of Belfast, Professor Sumitro Djojohadikusomo of Djakarta, Professor Goudriaan of Pretoria, Professor Knorr of Princeton and Dr Olano of Buenos Aires. Professor Goudriaan was elected chairman; and the report of the committee, entitled "Commodity Trade and Economic Development", was published during December 1953.

By this report the committee has faced world opinion once more with the true character of the problem of price

stability. In a very able and clear way the main characteristics of the phenomena have been summarised as well as the most important proposals so far made to deal with their adverse effects. And rightly one proposal has been placed much more in the foreground than discussions had so far, namely the proposal of the so-called raw material standard, made in this country by Professor Benjamin Graham as well as by Professor Frank Graham and almost simultaneously by Professor Goudriaan, then in Holland.

The proposal may seem revolutionary: its main contents is to accept, as the basis of our monetary system, not only gold, but also a so-called "raw material basket", i.e. a fixed combination of certain quantities of the most important raw materials. The basket may be e.g. 100 bushels of wheat, 50 bushels of rye, 80 bushels of corn, etc. It goes without saying that not the commodities themselves but indicative of their ownership should be the real subject of transfer. A basket would always be accepted by the Central Bank at a fixed (or almost fixed) price and equally be sold at a fixed price if anybody so desired.

By this technique - the details of which of course raise many questions - the stability of the price level would be chosen as the corner stone for our monetary system and, in a way, be guaranteed constitutionally. Before discussing the limitations of the system - which it does have, as any system - let us make its main consequences clear.

It would stabilize, to be sure, only one index of prices, namely, an index of raw material prices. By so doing it would, however, stabilize the general price level as well, at least with great approximation. For it is a well-known fact, proved by business cycle statistics for all countries and for a long period: the main source of price fluctuations is the unstable character of raw material prices. Prices of finished goods fluctuate before all since raw material prices fluctuate; wages fluctuate far less and as far as they do it is largely because of fluctuations in food prices, themselves an important component of general raw material prices.

The raw material standard would, on the other hand, stabilize one index, i.e. an average of raw material prices; not each of them separately. Far from being a disadvantage, however, this would be economically sound. It would leave intact the mechanism of demand and supply which determines relative prices between commodities and which counteracts any unhealthy tendencies towards overproduction or restrictionism. It would do no more than the monetary system should, according to the basic principles of economic science: fix the general price level which is not determined by the forces of demand and supply. In

the discussion between individual stabilization schemes and group schemes it decidedly chooses the latter's side, leaving as much to the free forces of the market as is reasonable and supplementing them at the very point where they have no function to perform.

The consequences would be important not only for the group of raw material producers themselves. They would mean the elimination of all unnecessary unrest in the general price level which also disturbs other sectors of the economy. The most important example is the influence of general price fluctuations on profit calculations. It is a well-known fact that there is a widely spread tendency for business firms to overestimate their profits in times of rising prices and to underestimate them when prices fall. Some authors have even maintained that this "accounting error" is the main cause of business cycles. Statistical evidence would at least show, it seems to me, that it is an important element. However this be it is well known that general price rises and falls also contribute to speculative stockpiling and destocking, as the case may be. Such movements would be largely eliminated, were the raw material standard applied.

Of course it should not be the only instrument of business cycle policy. The generally accepted instruments of public expenditures and taxes should keep their places. But their action would be facilitated and their extent reduced if the general price level would stop fluctuating as it did so far.

Certainly there would be several technical questions to be solved before the system could work smoothly. This article is not the place to go into them in any detail. The main question is the one of the costs involved. These costs will depend to a large degree on the extent of the additional stocks needed: they may be characterised mainly as carrying costs. The size of the stocks, in turn will depend on the other stabilizing policies applied: the more rigorous these are, the smaller the stocks needed in order to keep prices within the desired limits.

But it is not so much the object of this article to convince the reader at once that the raw material standard is desirable. It cannot be but an attempt to arouse interest for it. The United Nations experts have not tried so either; they only recommended a closer study of the system. This is the striking and somewhat ashaming fact: the system, although launched as long ago as twenty years has never been discussed adequately in the circles of the world's financial authorities. It is such a discussion we may now at least hope for.

J. Tinbergen

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