Causes of Loss of Competitive Position

There are two basic causes for our noncompetitive position and its unfavorable consequences for the balance of payments. One has to do with the inflation process, and the other with rigidities in the foreign exchange market. A nation's competitive position is determined by its wage rate divided by its productivity vis-a-vis other nations. At a given exchange rate, if the wage rate divided by productivity turns out to be the same for two nations, then they will on the average be competitive. If the wage rate in one country is twice that of the other and its productivity is twice that of the other, they will have the same average unit cost factor.

But wage rates and productivity factors may change differently for different countries over time. When this happens in a truly free international market, the exchange rate will change to keep the average unit cost factor the same.

Another important change took place following World War II, namely, the establishment of the International Monetary Fund and its control of exchange rates. Exchange rates are now fixed by this international bureaucracy and are not subject to fluctuation in a free market as they were early this century. Here we have a political rigidity which affects one important part of the international market.

The present exchange rates were fixed soon after World War II, long before anyone could foresee the resurgence of Europe and Japan and the phenomenal increase that they have made in productivity. Their productivity has increased about twice as fast as ours, and they have not matched their rapid productivity gains with equally large wage rate increases. As a consequence, they have improved their competitive position vis-a-vis the United States.

Inflation

Another important factor is the inflation which we have sustained and which has not been matched by any devaluation of the dollar or exchange rate adjustment.

We noted previously that money is a tool used to assist in the economic exchange process. If the amount of money is kept in step with the amount of goods and services to be exchanged, the exchange process can operate smoothly. If, however, hoarding (which draws money from circulation) or counterfeiting (which adds excess money) distorts the money supply in relation to the economy, the economic exchange process is disrupted.

Private counterfeiting, although constantly being tried, has never become large. The creation of worthless, paper, fiat money by monetization of the Federal debt, however, has reached major proportions. This type of "printing press" money has an effect on the exchange process similar to that of private counterfeiting. During World War II, Korea, and subsequent years, Federal expenditures have often exceeded income. A substantial portion of the bonds covering this debt has been placed in the Federal Reserve System as new and additional money created out of "thin air." In this way, more than $100 billion of "printing press" money has been injected into the banking system and this has served as a base for further credit expansion. By this