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MONETARY MANAGEMENT ABROAD AND AT HOME

There are many different attitudes toward the role and importance of what is called monetary management. If we assume that money leads the way in economic development, then the administration of money is about the most important task of government. On the other hand, if we assume that money follows rather than leads in economic change, then the function of monetary management is to keep money in its proper and subordinate place. If we assume that the function of money in the economy lies somewhere between these two extremes--probably the more correct view to take--then the monetary policy is one of several important factors that influence the course of economic development and the degree of stability which characterizes such development.

Monetary Postwar Problems

There is general agreement today, I believe, that monetary management is essential to economic stability. And for good reason. We have recently passed through an extended and disruptive period of world-wide war. Like all major wars in history, the second world war was partly financed by the creation of money--in short by inflation. Since the war, all the major participants have been seeking to adjust their economies to swollen money supplies. They know from hard experience that stable progress is impossible when economic activity is driven and distorted by inflationary pressures.

Attainment of postwar financial stability has been difficult enough in the United States. But our wartime monetary expansion, although dramatic, was moderate in comparison with that of the war ravaged countries of Europe. Also, our productive capacity was not subject to wartime destruction and our output is now greater than it was before the war. Consequently, we in the United States were subjected to neither unduly repressive postwar measures, like price controls or rationing, nor excessive open price and wage inflation. The problem of dealing with monetary expansion becomes extremely difficult only when accompanied by a sharp drop in the available supply of commodities, such as occurred in most countries of Europe and the Far East.

After the first world war, in most countries of Europe, monetary management had been confronted with a similar situation. It took more than half a decade to restore some kind of monetary stability in the most important countries of Continental Europe. That stability was reached only after a number of nations, and especially Germany, had experienced uncontrolled hyper-inflation that reduced the value of money almost to zero. By comparison with the events following the first world war, the results of monetary management following the second world war have been very good indeed. This time, inflation was curbed in most countries within three years after the end of hostilities, and there are reasons for believing that postwar inflation has been curbed for good.

Monetary Stabilization in Western Germany

The most noteworthy example of success in monetary stabilization is that afforded by Western Germany. In that country wartime government expenditure had expanded the supply of money to about ten times the amount that would have been needed under normal economic conditions, and perhaps twenty times the amount consistent with the level of economic activity actually existing immediately after the war. Western Germany's currency reform of June 1948 reduced the existing supply of money by more than 90 per cent; most holders of currency and bank deposits received only one new mark for 16 old ones. Economic activity picked up immediately. Previously, with money virtually worthless, incentives for harder work and better management were almost entirely lacking. Restoration of a sound monetary system provided fresh incentives for both, raising the level of production by two-thirds within less than a year.

While Western Germany still has a long way to go to complete economic recovery, the standard of living of its population at present is probably not appreciably lower than that of other Western European countries. Furthermore, the country is well on its way to becoming again a leading industrial nation, and should be able to contribute to the general rehabilitation of Continental Europe. Monetary stabilization, of course, was not the only reason for that sudden change. Stabilization was accompanied by a radical reduction of government restrictions of economic activity and by substantial grants under the European Recovery Program. Without financial stabilization, however, action to decontrol would have been impossible and our economic aid would have been largely squandered.

Monetary Stabilization in France and Italy

In a less spectacular way, similar developments have taken place in France and Italy. In both countries, monetary over-expansion had been about as bad as in Germany, but the economic consequences were less disastrous, mainly because controls hampered economic activity less seriously. In Germany, inflation was "repressed"; that is to say, effective controls prevented prices and wages from rising. In France and Italy, inflation came more into the open; the authorities were unable to keep prices stable. The continuous rise in prices hampered the revival of production less than the "repressed" inflation of the kind that prevailed in Germany. However, the rise in prices impaired the competitive position of French and Italian export industries in world trade and thereby intensified balance-of-payments difficulties. These difficulties, arising from having to pay more foreign exchange to other countries than was received from them, have plagued all European countries since the war.

In France, postwar inflation was stopped after the middle of 1948. This was accomplished in part by restrictive credit policies and by fiscal measures; in part it reflected the effects of a good harvest. Between that period and the middle of 1949 industrial production rose by about 25 per cent. In an even more decisive movement, the volume of exports rose by 40 per cent while imports remained approximately constant. As a result, the deficit in the balance of trade was cut to one-fourth, from a monthly average of $110 million in 1948 to $28 million in the summer of 1949.

In Italy, financial stabilization was virtually achieved in 1947, as the result of the strict monetary policies of the government. Between 1947 and 1948 the volume of exports increased by 40 per cent, with imports remaining constant. Thus the excess of imports over exports was cut in half, from $800 million to $400 million per year. In both countries ERP assistance was essential to bridge the remaining gap and was helpful in blocking further inflation; but that aid would have been largely dissipated if it had not been accompanied by financial stabilization.

Monetary Difficulties in the United Kingdom

An example of a different kind is provided by the United Kingdom. The economic situation in that country, which is more dependent than any other upon foreign trade and international finance, is too complicated to permit easy generalization. Few observers doubt, however, that the repressed inflation from which the country has been suffering since the end of the war has played an important role in its economic difficulties. Between 1938 and 1946, the supply of money in the United Kingdom rose about three times as much as prices and wages, while production remained virtually unchanged. A large inflationary potential thus remained unabsorbed and made necessary the continuation of stringent wartime controls. Between 1946 and the present, production increased by one-third. Even so, upward pressures on prices and wages remained a factor disturbing not only the possibilities of domestic progress but especially the prospects of attaining a balance in Britain's international trade.

The inflationary situation in Britain, as usual, reflected an excess of consumer capacity to buy over the available supply of commodities and services at prevailing levels of prices. As a result, there was a particularly strong demand for imports and for the domestic use of exportable goods. Since a hard core of imports is essential for the very existence of the British people, Britain has experienced great difficulties, despite stringent controls, in keeping imports from rising. At the same time, the country has been confronted by a growing inability to meet the competition of other exporting nations on foreign markets. As long as the world-wide scarcity of goods was so pressing as to permit the sale of virtually any exportable surplus, there was no serious problem of finding markets for exports. When the world export boom began to slacken, however, the rise in exports which had been the just pride of Britain's economic management slowed down and exports to the dollar area fell substantially. Unfortunately, it was impossible to bring about a drop in imports. The balance-of-trade difficulties and the so-called dollar shortage in the countries that use sterling currency (the sterling area) thus can be at least partly explained by the difficulties which the United Kingdom encountered in its effort to stabilize its domestic monetary system.

Change in Dollar-Sterling Rate

Repressed inflation in the United Kingdom was a very important element in precipitating the recent wave of currency devaluation. What happened may be explained this way. It was impossible, as a matter of practical politics, to adjust the swollen domestic money incomes plus the accumulated buying power in the form of liquid asset holdings to the

available supply of real goods and services--either by cutting down the volume of money through a currency reform of the German type, or by permitting the price level, but not the wage level, to rise as in France and Italy. Therefore, the only alternative for Britain was to reduce the entire monetary level of the domestic economy in relation to world market prices by curtailing the value of the domestic currency in terms of the world's most stable currency, the U. S. dollar.

Re-establishment of Britain's international balance may be achieved through the effects of this action on imports and exports. On the import side, the rise in the domestic price of dollar imports may keep dollar imports down by increased reliance upon the market mechanism rather than by arbitrary and disturbing rationing. In other words, people will buy fewer imported goods because imports have become too expensive, not because of Government controls. On the export side, the main result is an inducement to producers in Britain and throughout the sterling area to divert a larger part of their total production to the export market at existing dollar prices. In other words, since the equivalent of say 100 dollars now yields about 36 pounds to the British producer, instead of 25 pounds, exports to the dollar area have become more profitable. Moreover, by increasing the margin between costs and prices, devaluation makes possible more aggressive competitive efforts, including price competition. British domestic costs have been cut, if not in comparison to British prices, at least in relation to international dollar prices. It is true that these results might be endangered if British labor were to insist on increasing wage rates in proportion to the devaluation, or if increased taxation counteracted the incentives for management to raise exports. But if a substantial rise in British domestic costs is avoided, there is indeed hope that devaluation may contribute towards the realization of British financial stability.

It is pertinent to observe that many other countries decided to join the British in devaluation, including such countries as France and Italy which had already curbed the danger of inflation. If they had not so joined, the improved competitive position of the British exporters would have threatened the success which French and Italian anti-inflationary policies have had to date. In both countries, monetary stabilization has been too recent and is still too precarious to withstand great shocks. This development indicates plainly how problems of financial stability in one country affect not only that nation itself but the entire world economy.

Problems of Excessive Monetary Stability: Supply and Composition of Credit

Recent European monetary experience gives ample proof, I think, of the crucial role that attainment of financial stability must play in economic rehabilitation. It further shows, in my opinion, that curbing of expansion in the money supply does not complete the task of monetary management. Two additional problems are particularly important.

The first problem grows out of the danger that too great a stability in the supply of money and credit may lead to recession, or at least to an unwarranted slowing down of economic progress. An expanding economy needs an expanding supply of money and credit, and the lack of necessary expansion may bring about a deflationary situation.

The second problem relates to the fact that not only the quantity but also the composition of credits affects an economy's progress. It often happens that short-term credit is ample but long-term credit insufficient. In that case, the oversupply of short-term credit may lead to inflationary symptoms in some parts of the economy while the scarcity of long-term credit may lead to recession in other parts.

Deflationary Tendencies in Western Germany and Italy

Some observers believe that in Western Germany and in Italy monetary management has recently over-emphasized the objective of stability of the money supply, and that the gains of stabilization may thus have been jeopardized to some extent. These two countries have received high praise because of their management of money and credit. Both nations have been able to end a period of inflation without catastrophic disorganization of their economic structures. In both countries, however, some recent tendency toward a slowing down of recovery and a reemergence of unemployment has appeared.

In neither of these countries could this tendency be explained mainly by ultra-prudence in monetary management. Italy has suffered from overpopulation for many years, and unless it finds new ways of utilizing its excess manpower, the problem probably will not be solved except by large-scale emigration. Just for that reason a rapid rate of industrialization is extremely important to Italy's further recovery. Weather conditions, affecting the supply of hydro-electric power, may also to some extent be responsible for temporary stagnation. Some critics contend, however, that the disinclination of the central banking authorities to refinance sufficient credits bears a share in the responsibility, and that as a result of this policy, Italy has not been able to utilize all the possibilities opened by the aid granted under ERP.

The situation is similar in Germany. After the astonishing success of the currency reform of June 1948, production moved at a breath-taking pace until March 1949, when it reached 90 per cent of 1936. By that time the fear of renewed inflationary developments had induced the central banking authorities to concentrate upon the struggle against overexpansion of money. Monetary management, aided by other contributing influences, indeed succeeded in preventing inflationary tendencies during the fall of last year from developing further. But industrial production soon stopped its rise and did not reach the March level again until August 1949. Unemployment increased to more than 1.2 million, or 9 per cent of the employed labor force.

As in Italy, the rise in unemployment in Western Germany is attributable in large part to causes which could not be remedied by monetary management. The inflow of 8 million refugees from Eastern Germany has disturbed the balance of the population, and unemployment is particularly strong in those areas in which the refugees have settled. Some analysts believe, however, that not more than one-third of the total unemployment could be explained in this way and that it would help to eliminate at least part of the remaining two-thirds if appropriate credits were being made available to German industries.

The management of the German banking system has good reasonsto

beware of credit policies that might again bring about the slightest trace of new inflation. In view of the extremely unstable domestic and international political situation in Germany, however, the recent rise in unemployment, with its accompanying social tensions, is particularly dangerous. Re-emergence of the specter of unemployment that haunted Germany in the thirties might sooner or later lead to an overthrow of the present administration and to dangerous monetary experiments. On the other hand, the recent development may be nothing more serious than the inevitable consequence of the transition from an inflationary to a reasonably balanced situation.

Long-term Credit Problems in Western Germany

The example of Western Germany also shows the importance of the composition of the supply of new credit. Most economists agree that lack of sufficient investment is frequently the cause of unemployment. Often the insufficiency of investment is due to lack of opportunities for profitable expansion, or to a scarcity of manpower and natural resources; but under present conditions it is often ascribable to the lack of long-term credit. In countries which suffered from wartime destruction and from inflationary developments in the postwar period, private savings--which normally form the basis of long-term credit funds--are generally at a low level. The gap therefore has to be closed either by the banks with the help of the central banking system, or by public authorities. Large-scale creation of long-term credit by the banking system is generally considered to be unsound and unsafe banking practice. It has inherent dangers of inflationary over-expansion and is likely to be followed by a period of contraction, made more difficult by frozen bank assets. Large-scale credit creation by public authorities usually either has inflationary implications (if based on deficit finance) or requires that taxes be maintained at, or increased to, very high levels. But high taxation tends further to reduce private savings and investment. Both methods have to be used with the greatest caution, and are at best poor substitutes for the formation of capital out of private savings.

In Western Germany the central banking authorities have been extremely reluctant to extend rediscount and similar facilities to long-term credit institutions. Very recently, the central banking system, after long deliberation, has been permitted to refinance 300 million marks, or about $72 million, of medium and long-term credits, but this sum is very small in relation to needs. The Reconstruction Loan Corporation, which has the function of financing investments, has so far received loan applications for 7.4 billion marks, but has been able to grant loans of only 0.4 billion. This situation has led to an increasingly large role by public authorities in financing new investment, largely out of current tax revenues. The prominence of government financing contrasts heavily with the intention of the German government to return as fully as possible to a free economy based upon private initiative. Moreover, the government itself has recognized that the existing level of taxation is a serious obstacle to further economic progress, sapping incentives for both labor and investment. The only part of public investment that is not based on taxation utilizes the so-called counterpart payments, namely the payments received by the local government from purchasers of goods imported by means of U. S. aid. These funds, however, can be invested only according to a program which has to be approved by our Economic Cooperation Administration.

Accordingly, the release of these funds is a complicated process. Counterpart funds, moreover, will not be available after the end of the European Recovery Program. Reestablishment of a well-functioning domestic capital market is thus one of the most important goals of fiscal and credit policy in Germany, as it must also be in many other European countries which seek to recover from the distortions caused by the recent war.

Long-term Credit Problems in Low Countries

Another example may help us to understand the importance of the problem of long-term credit utilization. Belgium and the Netherlands are two neighboring European countries very similar in size, population, and economic, social, and political conditions. Not long after the war, they reached an agreement to form an economic union. Since then, their economic fates have taken very different turns. It is true that a large part of these differences may be explained by events beyond their control. Belgium was liberated in 1944 and suffered very little war damage while the Netherlands was liberated many months later and only after heavy destruction. Belgium's colonial possession, the Congo, remained under Allied administration throughout the war and in postwar years has become extremely prosperous. Indonesia, the main overseas territory of the Netherlands, was for many years under Japanese domination and has been ravaged by civil war ever since the end of the Japanese rule so that it has become a burden rather than an economic advantage to the mother country. Moreover, the Netherlands has been hit far more severely than Belgium by the impoverishment of Germany, with which it had very close economic ties.

It is therefore not surprising that Belgium has recovered more fully and more rapidly than the Netherlands. To some extent, however, the difference in development also may be due to a different course of economic and financial management. The Belgian authorities promptly adopted a successful currency reform in 1944, which set the pace for all other Western European attempts of that kind and also permitted Belgian industry to become geared to the satisfaction of consumer demands rather than to a high degree of investment. The Netherlands' authorities, on the other hand, embarked on one of the most ambitious investment programs of Continental Europe, destined to overcome as rapidly as possible the destruction caused by the war and also to provide for a rapidly increasing population.

As a result of all of these factors, Belgium soon was able to regain a higher degree of financial stability than most of its neighbors and to dispense with virtually all wartime controls of private economic activity. As in so many other countries under conservative financial management, however, there have been some recent signs of slackening progress and rising unemployment. These developments may be interpreted either as reflecting deflationary troubles or as indicating a transition to a normally balanced economy. In any case, the Belgian currency is today, next to the Swiss franc, the most coveted European currency.

The Netherlands, on the other hand, has been confronted with great difficulties in meeting the capital requirements of its investment program and has felt compelled to retain a system of strict government

controls over most phases of its economic life. Furthermore, it has been allocated a very large amount of aid under the European Recovery Program while Belgium not only has not received any net assistance but has undertaken to provide credits for less fortunate European nations. Despite that aid the Netherlands must still follow a policy of strict austerity and has shown until recently familiar symptoms of repressed inflation. Advantageous as its large investment program may prove to be in the long run, it certainly has outrun the country's capital resources. Only as a result of truly heroic efforts have the Netherlands people in recent months come somewhat nearer to internal and external financial stability.

Conclusions: Monetary Problems of the United States

Let us now recapitulate the results of our hurried review of monetary management in Europe. The example of Western Germany, France, Italy, and Belgium has demonstrated the overwhelming importance of financial stability for achieving and maintaining prosperity. The case of the United Kingdom has shown us how fundamentally a financial disequilibrium in a major country affects the international financial relations of the entire world. However, the examples of Western Germany, Italy, and Belgium have indicated the necessity for supplementing stability by the guaranteeing of a steady flow of credit so as to avoid the danger of interrupting economic growth. Finally, the development of Western Germany and the Netherlands has shown the special importance of a sufficient supply of long-term credit as a source of expansion and progress.

Each one of these countries has tried to solve its problems in a different fashion. I am anxious to emphasize that my discussion of these differences should not be interpreted as criticism. Every government must deal with a complex social and political situation, and a policy that seems best to the outsider may be impossible to pursue. The danger of inflation, for instance, appears in a very different light in Germany after two hyper-inflations in one generation, and in Britain, where the currency has never become worthless. France, which has also suffered from inflation in the past, nevertheless seems to prefer inflation to government controls, in contrast to the Netherlands, which has not had a serious inflation. While the problems themselves are the same the world over, the solution that would be right for one country might be wrong for another.

It remains only to consider very briefly the application of these results in our own country. The United States, like all other countries involved in the second world war, had to finance the war to a large extent by inflationary methods. Postwar readjustment of our economic system, despite the vast monetary expansion during the war, has been greatly facilitated not alone by our tremendous productive capacity but also by the high degree of public confidence in money and Government bonds and the willingness of the public to hold large amounts of these assets as liquid reserves. This willingness to hold liquid reserves permitted a rapid reconversion and a tremendous increase in civilian output during the years following without completely upsetting our price system. We are all aware that we did have a substantial rise in prices and wages, but it might have been much greater if monetary management had not taken measures to keep the inflationary tendencies under control.

International Aspects of U. S. Monetary Management

Domestic monetary management in this period could not concentrate exclusively upon our domestic problems. The United States could re-establish a lasting prosperity only in a world which in turn enjoys a reasonable degree of stability and prosperity. It was therefore vital for the success of our own financial reconversion from war that we aid in the rehabilitation of the chief trading countries of the world. To this end, we made very substantial loans and grants to European and Far Eastern countries. Moreover, in order to ensure the adequate utilization of these loans and grants, we had to interest ourselves in the problems of domestic financial stability of the countries to which we extended our aid.

Our influence upon financial developments in foreign countries rests in considerable part upon our voice in the use of the counterpart funds. These funds represent the payments in local currency made by the purchasers of the goods imported under our relief programs and especially under the grants of the European Recovery Program. The counterpart funds are legally the property of the local governments. But the governments are pledged to dispose of them only with our expressed approval. In many countries these funds are large enough so that decisions as to their use or non-use have fundamental effects upon financial stability, expansion, or stagnation.

In these decisions we are confronted with the very problem which was the main subject of our discussion, namely the choice between insisting upon strict stability in the supply of money or permitting a moderate expansion. In the first case, we may invite stagnation. In the second, expansion may go too far and end in an inflationary spiral. Wise decisions involving the use of counterpart funds can claim some credit for stopping inflation in Europe, but difficult questions remain to be solved in countries now threatened by a stoppage in progress and by rising unemployment.

Domestic Aspects of U. S. Monetary Management

To a lesser degree, these same problems confront monetary management at home. The threat of inflation, which darkened our economic prospects in the prosperous years from 1946 through 1948, was followed by a slight downtrend in our economic activities, which began in the winter of 1948-49. This downtrend, however, may be hailed as a necessary and inevitable readjustment. The pent-up demand for goods and services that had not been available for many years was bound to disappear. Labor and management have been making adjustment to a more normal level of demand, entailing a reduction in output and prices that had risen out of proportion to the development of the economy as a whole. The supply of money has been more stable between the middle of 1948 and the middle of 1949 than at any other time since the beginning of the second world war.

It is true that during the past twelve months our industrial production declined by 12 per cent and the number of our unemployed, although still at a low level, was almost doubled. In recent months, however, an upturn in sales and in production has been evident, although output is now being curtailed by strikes. The devaluation of many

foreign currencies may pose some short-run problems in our international trade before its long-run benefits become apparent. These facts indicate the difficulties of the task with which we are confronted.

From our domestic as well as our foreign experience it has long been recognized that the objective of monetary management must be to regulate the supply, availability, and cost of money with a view to contributing to the maintenance of a high level of employment, stable values, and a rising standard of living. Economic progress involves the absorption of an ever-increasing number of workers together with an ever-increasing productivity per worker in a way that will not lead to unsustainable expansion. Monetary management alone cannot achieve these results, but without monetary management they are not likely to be reached at all.

The United States is at present the leading country of the free world, both because of its material resources and because of dogged adherence to the principles and practices of free enterprise. Our economic fate will determine the economic and political future of many other nations. We must achieve steady economic progress, without inflation or serious depressions, not only for our own sake but also to reinforce the faith of the rest of the world in the economic and social principles for which we stand.