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Remarks

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ECONOMIC GROWTH, INFLATION, AND STABILIZING POLICIES

The relation between economic growth, inflation, and stabilizing monetary and fiscal policies has become a central topic for argument, in matters politic as well as economic. Until comparatively recently, few persons questioned that inflation was harmful to sustainable economic growth over the long run, and that stabilizing monetary and fiscal policies could render a distinct service to economic growth by helping to contain inflationary pressures. Nowadays, however, both these statements are being challenged. The challengers assert that economic growth is not likely to occur without at least some degree of so-called creeping inflation, and that stabilizing monetary and fiscal policies either are unable to halt such inflation or are able to do so only at the cost of stunting economic growth.

It is not my purpose to discuss this problem on the basis of theoretical reasoning. Neither do I intend to illustrate it by referring to experiences in the United States. The Federal Reserve has been deeply concerned with these experiences, and it would be impossible for me to talk about them without trying to evaluate the policies of the Federal Reserve. For obvious reasons I might not be considered an unbiased judge of these policies, and therefore I shall avoid this subject altogether.

In recent years, however, the relation between economic growth, inflation, and stabilizing monetary and fiscal policies has played just as important a role in the economy of other nations as in the United States. In fact, I believe that the basic problems concerning that relation can be brought out more clearly if the problems are illustrated by some recent examples of foreign experiences than if they are discussed in the framework of

present United States policies. We can look at happenings abroad and in particular at the relative role of government policies and of accidental changes in economic circumstances with greater detachment and objectivity than at similar events nearer home.

I shall today select four such examples, which concern countries that are comparable to the United States in terms of economic strength and economic institutions: Germany, the United Kingdom, France, and Japan. Each of these countries has been confronted with the problems of sustaining economic growth and at the same time combatting inflationary pressures. Each of them has tried to solve this problem by applying stabilizing monetary and fiscal policies (as well as other government actions) in different ways and in different degrees, and while it will be evident that each country has its own peculiar conditions, situations and problems, their experiences nevertheless may give us some aid as we face a similar problem in the United States.

It is obvious that time will not permit the detail that the subject matter may suggest.

Developments in Germany

After the currency reform in June 1948 the German economy expanded at a very rapid rate, and during most of the period 1948-58 prices rose more slowly than in most other European countries. Between 1950 and 1958, the national product increased by 62 per cent, measured at constant prices, while the cost of living rose by 18 per cent. Germany gradually and steadily removed most of its restrictions on trade and payments after recovering from its balance of payments crisis in 1950-51; and it also increased its net gold and

foreign exchange reserves from \$90 million at the end of 1949 to more than \$6 billion at the end of 1958.

These developments were accompanied by a flexible and well-timed monetary policy, and, during the years of most rapid growth between 1952 and 1956, by substantial budget surpluses. The German monetary and fiscal authorities adopted the view that policies favoring price stability and the rebuilding of foreign exchange reserves would in the long run best serve the other economic goals of economic growth, a rising standard of living, and full employment.

This approach to monetary and fiscal policy was severely tested on several occasions in the first few years following the currency reform, particularly during the Korean War boom of 1950-51. Between 1948 and 1952, when their money and capital markets were--so to speak-- in their infancy, it was found necessary to supplement the traditional monetary techniques with certain direct controls. Since that time, the traditional techniques have proved sufficient to handle the stresses generated in the economy.

By 1952, Germany had weathered the severe crisis stemming from the Korean War boom, and its economy was back on an even keel. It had recovered from the war-time devastation, and the monetary reform was consolidated. Germany was ready for a new phase of economic development and expansion, as a full-fledged member of the international economic community.

Between 1952 and 1955 the economy grew at a very high rate. Industrial production increased by over 40 per cent, unemployment was sharply reduced, and most industrial plants were working at near-full capacity by mid-1955. Prices remained fairly stable in 1953 and 1954, but began to move up in 1955.

With these signs of what in Germany was called "overheating" in the economy, the central bank raised the discount rate in several steps from 3 per cent in August 1955 to 5-1/2 per cent in May of 1956; rediscount quotas (amount of credit banks may receive from the central bank) were tightened and large-scale open market sales were undertaken. (Thus reducing the reserves the banks might otherwise use for lending.) Moreover, the Federal government kept the budget regularly in substantial surplus between 1952 and mid-1956.

These actions, collectively, were successful in checking the excesses of the boom, although the central bank still had to contend with an influx of speculative funds from abroad--particularly as a result of the Hungarian and Suez crises toward the end of 1956--which threatened the stability achieved during the summer of that year. Open market sales of government securities by the central bank and an increase in bank reserve requirements were successful in absorbing a substantial part of this unwanted growth in monetary resources.

Owing to the policies followed, as well as to the fact that the world-wide boom had about run its course, demand pressures continued to ease. Beginning in September of 1956, therefore, the discount rate was gradually lowered; and interest rates in the money and capital markets started the downward trend which today has brought them to a level approximating those in other major financial centers. Between mid-1956 and the first quarter of 1958 the budget was permitted to show a deficit.

During 1958, when world-wide recessionary tendencies began to be felt in Germany, the monetary authorities continued to reduce the discount rate, and they adopted a largely passive position toward the continued rise in liquidity resulting from foreign exchange inflow. As interest rates fell,

there was a widespread revival in the capital market, and construction activity boomed during the year, giving major support to the economy. However, the budget deficit was eliminated; between April 1958 and February 1959 (the latest date available at time this paper is being written), government revenues and expenditures were in virtual balance.

Developments in the United Kingdom

Since the pegging of short-term interest rates was abandoned in November 1951, Britain has relied on monetary policy to achieve an important part of the desired restraint in internal economic activity, and to correct the balance-of-payments consequences of over-full employment at home. From 1955 to 1957, however, monetary, fiscal, and instalment credit restraints were unable to check excess demand pressures and the virtually continuous round of price and wage increases which averaged over 4 per cent a year. The monetary authorities were hampered by a weakening of fiscal policy and by difficulties in the field of government debt management as credit conditions tightened. A major foreign exchange crisis forced the authorities in September 1957 to raise Bank rate from 5 to 7 per cent and to reduce government spending.

Early in 1955, the British authorities resorted to monetary measures to keep the private investment boom under control, raising Bank rate in January and again in February. However, a substantial relaxation of fiscal restraint occurred in March when the budget for 1955-56 was introduced and taxes were reduced. As a result, the Treasury's over-all deficit (for current and capital expenditure) was increased to £300 million. Also, additional tax rebates to encourage private investment

were introduced, even though the full impact of similar incentives introduced in 1954 had not yet been fully felt in the growth in private investment.

The growing momentum of business expansion was marked by a record expansion in bank loans for the first six months of 1955. To check this credit creation, the Chancellor imposed a quantitative ceiling on bank lending in July 1955 in which he called for a "positive and significant reduction" in loans. As a result, the banks did bring about a 10 per cent reduction in their loans by the end of 1955.

The government soon found itself faced with major public debt-management difficulties. They were unable to sell Government bonds to raise funds for the capital spending of the nationalized industries and local authorities; they were also faced with heavy attrition on maturing bonds as private and institutional investors exercised their cash option to obtain funds for private investment purposes. These difficulties, together with the growing inflationary pressures, led the Chancellor to introduce an extraordinary fall budget in October 1955 in which he increased purchase (i.e., sales) taxes on consumer durables, reduced certain capital expenditures and forced local governments to borrow from the capital market rather than from the Treasury.

The restrictive fiscal measures were followed in February 1956 by a further rise in Bank rate and by the introduction of higher down payment conditions for instalment credit purchases. In addition, the Chancellor tightened fiscal measures further in his budget for 1956-57 introduced in April. Government spending was brought under more control and the special private investment incentives were withdrawn.

During 1956 and 1957, business activity continued at peak levels in the face of high money rates and the restrictive fiscal measures. During the two years, prices rose by 4 per cent a year and wages by 5 per cent. Finally in September 1957 a severe loss of gold reserves led the authorities to raise Bank rate from 5 to 7 per cent, to limit bank loans and to restrict government investment. These measures were taken, however, at a time when world economic developments helped to check inflationary tendencies. The U. S. recession helped to calm down inflationary psychology in Europe and there was a substantial fall in the prices of the raw materials Britain purchases from abroad. In addition, Britain's own investment boom began to taper off in late 1957.

The results of Britain's emergency measures have been to enable Britain to take advantage of lower import costs. The United Kingdom has been able to check, at least temporarily, the postwar inflationary rise in prices and to strengthen its balance of payments, so that it could introduce convertibility to foreign-held sterling in December 1958. It has also been able to relax internal restraints on bank credit and on installment purchases and to turn fiscal and monetary policies to the task of economic expansion. The ceiling on bank loans was abandoned last July, all installment credit controls withdrawn two months later, and taxes were substantially reduced in the budget for 1959-60 introduced in April.

Developments in France

In December 1955, a decline began in France's official reserves of gold and foreign exchange that lasted for two and a half years, and amounted

to the equivalent of nearly 1.5 billion dollars. This situation was caused by over-expansion in economic activity and the consequent excess of inflationary pressure.

The French economy expanded at a rapid pace in 1954-1955, without signs of developing inflationary pressures, because unused resources were being absorbed into the productive process. After 1955, expansion could not continue at the same rate without causing prices or imports to rise. The latter tended to happen first. In 1956, strong demand on the internal market absorbed a record volume of imports, gave French business comparatively little incentive to export, and caused a trade deficit of more than one billion dollars. During this period, prices were kept down by the flood of imports, and also by detailed administrative measures designed to keep the cost-of-living index from rising. From the end of 1955 through July 1957 the French official cost-of-living index rose by less than 2 per cent. During the same period, however, France lost over half of its official reserves of gold and dollars. At this point--August 1957--the French government carried out a de facto devaluation of the franc by 17 per cent. Nevertheless, prices rose sharply, and continued to do so until the spring of 1958.

The main causes of inflationary pressures in 1956 and 1957 in France were the classic ones. The French economy was caught up in a world-wide upswing in demand, which was reinforced at home by inflationary financing of a large government deficit. The French budgetary deficit in 1956 and 1957 amounted to about 20 per cent of expenditures, and bank credit to the private economy expanded in those years by 22 and 15 per cent respectively. Although to some extent the budget deficit was financed by drawing on the savings of

the public (especially in 1956), the combined total of central bank advances to the government and of net new bank credit to the private economy in each of the two years proved to be excessive.

In the spring of 1957 the French authorities began to take some of the steps necessary to curb the expansion of the money supply. The discount rate was raised to four and later to five per cent. The penalty rates for each bank's discounts above certain ceilings at the central bank were raised to 7 and 10 per cent, and in the latter part of 1957 the ceilings themselves were lowered by 35 per cent. Certain more direct measures to reduce the flow of imports were also adopted, including the reimposition of quotas on virtually all imports. These measures slowed down but did not stop the expansion of credit, or the loss of foreign exchange, which in the fall of 1957 was accelerated by speculation against the franc. At the end of 1957 France was again forced to seek loans to bolster her depleted reserves of foreign exchange. In connection with the \$655 million aid package that France received from the International Monetary Fund, the European Payments Union, and the United States, the French government undertook to carry out a stabilization program involving principally a reduction in the budgetary deficit and further tightening of credit controls.

France's balance of international trade and payments improved during the second half of 1958, owing in part to the measures previously put into effect, in part to the confidence engendered by the de Gaulle regime, and in part to slackening of economic activity that began in the spring or early summer. French prices, however, were judged to be too high to compete

on world markets at the rate of exchange then in effect. Consequently, at the end of December 1958 the French franc was again devalued--this time by 15 per cent.

France now faces the prospect of a new upswing in activity with its economy on a sounder basis than for a number of years, but it is not without serious economic problems. Foreign exchange reserves are still comparatively low, and there is little slack in the economy. The fighting in Algeria continues to be a drain on the budget. The new French government, however, appears to have a better chance of successfully coping with these problems than any of its recent predecessors, mainly because it is evidencing determination not to let inflation again undermine its currency.

Developments in Japan

Japan has had a long history of inflation in the postwar period, but I will confine myself to a discussion of post-Korea experience. Since the end of the Korean war Japan has undergone two inflationary booms, both of which have been remarkably similar in their nature and in their consequences. The booms have been characterized by easy money policies that permitted demand to expand more rapidly than the available supplies. Output rose, but as demand rose even faster prices were pushed up. In both cases the inflationary pressure very quickly produced trouble in the Japanese balance of payments.

Japan is highly dependent upon foreign trade. The total value of exports and imports is equal to nearly one-fourth of its national product. The development of foreign-exchange difficulties was the prime factor in spurring the Japanese authorities to take action to suppress the inflation in both 1953

and 1957. It might also be said that the awareness of the Japanese public of the relationship between domestic financial stability and external balance has been of great importance in winning public support for the rather strong medicine that the authorities have applied.

In 1953 Japan experienced a sharp rise in imports while exports remained virtually unchanged. Reserves of gold and foreign exchange fell about one-sixth during the course of the year. It became evident that the prices of many Japanese export commodities were less competitive than they had been previously, and the buoyant home market made it less necessary for Japanese producers to devote time and energy to the promotion of export markets. Talk of devaluation of the yen became widespread and the government instituted various special export-promotion devices to encourage greater interest in selling abroad and earning the foreign exchange necessary to pay for the rapidly rising volume of imports. Anti-inflationary measures were introduced in October 1953, with the initial emphasis on tighter credit, followed by fiscal retrenchment in the spring of 1954. The authorities stated that their aim was to bring about a 10 per cent reduction in prices. They fell a little short of this goal in terms of the overall wholesale price index, but very substantial reductions were achieved in many lines, and interest in export business was remarkably stimulated. At the time Japanese prices were being reduced, prices in several competing countries were creeping upward, and Japan found itself in a very strong competitive position in export markets. In 1954, exports rose rapidly and imports fell. The following year saw continued internal financial stability, a very respectable rate of increase in industrial activity, and another huge increase in exports. Japan's gold and foreign exchange holdings rose to record levels.

The next inflationary boom began in 1956, with a very rapid acceleration in output and with demand again running ahead of supply to bring a price increase of more than 8 per cent for the year. Exports continued to rise, but imports rose more. During the course of the year it became increasingly obvious that Japan was heading for balance-of-payments trouble. Corrective action was delayed for several months, and by the time it was finally taken in the spring of 1957, Japan had reduced her gold and foreign exchange reserves by nearly 30 per cent from the total at the end of 1956.

Again a combination of monetary and fiscal measures was employed, with emphasis on higher interest rates and other measures to tighten credit. The authorities once more sought to achieve a price reduction of about 10 per cent, and a 9 per cent reduction in wholesale prices was actually achieved. This time the Japanese anti-inflationary efforts coincided with the industrial recession elsewhere in the world. Although exports were maintained at a high level, overseas demand was not sufficiently high to enable Japan to fully utilize either the greatly expanded plant or inventories that had been built up during the boom. Industrial activity, seasonally adjusted, declined 7.5 per cent from May 1957 to May 1958, which proved to be the bottom of the Japanese recession. Again the price and cost adjustments achieved during this period were important in enabling Japan to increase exports, though only slightly, in the face of declining world demand.

The balance-of-payments crisis was overcome in 1958 and Japan again began to accumulate reserves at a rapid rate and at the same time to increase production. Today Japan is well out of the mild recession of 1957-58. Industrial activity in February 1959, seasonally adjusted, was 18 per cent above

the low of May 1957. The outlook for continued prosperity and growth is excellent and Japan faces the future with her vitally important balance-of-payments in good condition, her reserves at near record levels, with a highly competitive industrial plant and managerial leadership, and a population that has developed an amazing propensity to save and invest in the future.

Conclusions

Other countries should be reviewed where economic and financial situations were and are different and actions taken were and are different, but time will not permit us to review them today. But what can we learn from the developments abroad so far reviewed?

The German example shows that a country can continuously pursue a policy of stabilizing monetary and fiscal policies and at the same time experience rapid economic growth. Needless to say, these policies in themselves were not the main causes of the country's growth. The German economy was stimulated by the need to rebuild its war-shattered cities and enterprises, by the inflow of highly skilled refugees from the East, by the world-wide boom in capital goods, which was of particular benefit to the industrial area of the Ruhr. Nevertheless, other countries experienced similar stimuli, and not all of them were able to take the same advantage of them. With all possible reservations it is impossible to doubt that the use of stabilizing monetary and fiscal policies has made a significant contribution to the enviable record of the German economy of the last ten years.

The examples of France and Japan show that rapid growth combined with inflationary pressure soon results in such serious balance-of-payments difficulties that rather harsh anti-inflationary measures become necessary.

The examples of these two countries and of the United Kingdom finally show that stabilizing monetary and fiscal policies can succeed in stemming even strong and sustained inflationary pressures if applied with sufficient energy and at the right time. It is again needless to say that these policies in themselves may not be able to do the job if the economic circumstances are unfavorable. The inflationary processes in the United Kingdom, France, and Japan were brought under control at a time when the end of the world-wide investment boom increased the effectiveness of anti-inflationary action. Nevertheless, there can again be no doubt that the end of the boom would not have automatically eliminated inflationary pressures if correct policies had not been followed: quite a few countries have been suffering from inflation throughout the recent recession.

I said at the beginning that I did not want to discuss the United States economy by direct reference. Circumstances vary, and every country has to choose its own economic and political goals and methods. Also, in no country do we have a clean sheet of paper to write upon. We have to take the situation as is, and not as we would like to have it be. We must deal with fact, not theory. However, if Germany has been able to combine financial stability with rapid economic growth, there is at least a strong presumption that the United States can do the same. And if the United Kingdom, France, and Japan have been able to stem inflationary pressures by adequate monetary and fiscal policies, there is at least a strong presumption that the United States can do the same. It should therefore not be too difficult to apply the lesson learned from the experience of other countries.