

# FEDERAL RESERVE BANK OF NEW YORK



## MONTHLY REVIEW

FEBRUARY 1960

### Contents

The Business Situation .....	18
Money Market in January .....	22
International Developments .....	25
Comments on Employment, Growth, and Price Levels: A Letter by William McChesney Martin, Jr. ....	27
Growth and Price Stability: The German Experience .....	29

Volume 42

No. 2

## The Business Situation

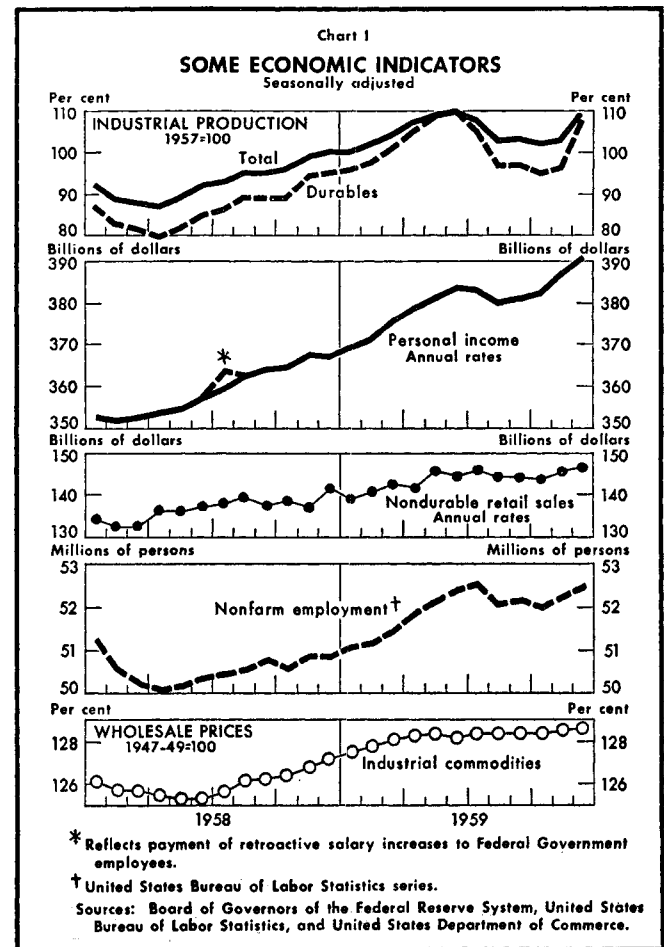
Economic activity continued strongly upward in the first month of the new year, as industry sought to satisfy the pent-up demand for steel and to increase the output of business equipment and durable consumer goods. New production records were posted in several fields, including steel, while automobile assemblies approached the previous high of November 1955. Investment expenditures, dampened during the steel strike, were on the rise; and outlays for consumer goods, supported by an advancing level of personal income and a further growth in consumer credit, were apparently pushing ahead to fresh heights. Yet, despite the strengthening in all sectors, there was a noticeable quieting of the tempo of increasing demand, compared with the preceding two months, and earlier fears of an imminent outbreak of fresh inflationary developments were not realized.

### THE CONTINUED ADVANCE

The need to rebuild business inventories depleted during the strike was a basic force in the upward momentum. By the end of November, the book value of total inventories had dropped \$1.5 billion below the July level, seasonally adjusted, and the ratio of inventories to sales was just slightly above the unusually low levels that had prevailed during the spring of 1959. In many lines, stocks were apparently run down further by excellent sales records during the year-end holiday season. The rebuilding of steel and automobile inventories, begun late in the year, went on apace during January. Although steel mills were operating at over 95 per cent of the 1960-rated capacity (established at 148.6 million tons as against 1959's 147.6 million), industry sources estimated that current consumption of steel was equal to only about 80 per cent of capacity tonnage, with the balance being added to stockpiles held by steel users and warehouses. Some part of this heavy inventory demand may have stemmed from anticipations of steel price increases following recent wage settlements. But inventory shortages were obviously widespread. Steel warehouses, for instance, which are the main supply source for smaller users, and normally carry about 20 per cent of the country's steel inventories, reported that they thought it would be April before they would be reasonably well stocked, and August before they would have adequate inventories in all products. Automobile dealers' inventories were also still low at the end of December. With only 575,000 cars on hand, their stocks

were slightly less than a year ago and more than 100,000 units below the 1955 and 1957 December levels. During January, however, stocks of cars moved up substantially, to an estimated 800,000.

A general increase in inventories could of course occur only after current demands for final goods by consumers, business, and government had been satisfied. The rise in stocks thus depended upon a rise in production beyond recent levels. Such a rise was evidenced by the new index of industrial production (described in more detail below), which bounced back from 103 in November (1957=100) to 109 in December, a level just 1 point short of the June peak (see Chart I). The principal element in this advance was the output of durables, which jumped 11 per



cent, reflecting particularly a sharp expansion of iron and steel and automobiles but also substantial increases in fabricated metal products and electrical machinery. The three other major components of the index—nondurables, mining, and utilities—rose too, but by much smaller amounts. The continuing high level of operations in many important fields suggests that the level of production for January will move beyond the record set last June.

The rise in December in industrial activity led to a further advance in nonfarm employment. The number at work rose to 52.5 million (seasonally adjusted), only 73,000 below the July record level. As in November, the ratio of unemployment to the total civilian labor force again moved down, dropping to 5.2 per cent after seasonal adjustment, compared with the 6.0 per cent reached in October as a result of the steel strike.

The gain in employment contributed to an increase in personal income that was almost as large as in November. On a seasonally adjusted basis, total income in December was at a record level, 2 per cent above the pre-strike high (see Chart I). Although most of the advance was in wages and salaries, farm income also improved markedly; by December, farm income had recovered two thirds of the 25 per cent dip in level that had occurred during the first nine months of the year. Indeed, the widespread gains throughout the economy following the resumption of steel-making operations early in November pushed up gross national product for the fourth quarter of 1959 to an estimated annual rate of \$482 billion (seasonally adjusted), \$3.4 billion above the third-quarter level. In real terms, GNP was still 1½ per cent below the high second-quarter rate but 3½ per cent above the 1958 fourth-quarter rate.

A drop in retail sales during the last two months of 1959, to a December level 4 per cent below October (seasonally adjusted), was accounted for by a decline in durables, attributable primarily to a shortage of automobiles. Demand for nondurables continued to move up in December, as Chart I shows. While preliminary figures for January department store sales do not suggest the same degree of strength in the demand for nondurables as in December, larger and more diversified stocks of automobiles are expected to stimulate auto buying and help increase total durables sales.

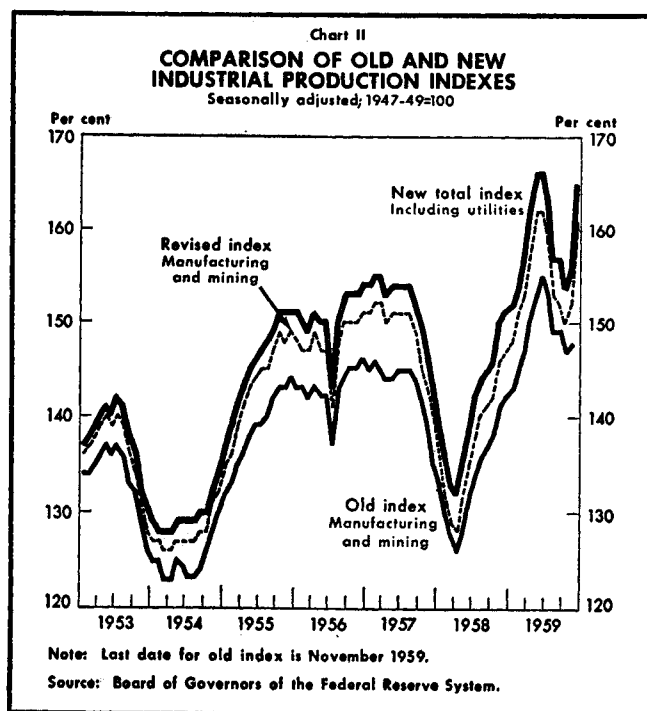
Continued strength in the economy was also indicated by the level of construction activity. On a seasonally adjusted basis, total construction outlays were up almost 6 per cent in January. However, the Census Bureau, which makes these estimates, believes that the December estimate of government spending on highways was too low, and that therefore the December-to-January increase in total expenditures was actually somewhat less than indicated.

Gains occurred in all three components of construction—the residential, the nonresidential, and the public sectors.

Prices, meanwhile, have remained relatively stable. The wholesale price index was unchanged in December, at 118.9 (1947-49), just fractionally under the year-ago figure and 1 per cent below the year's April high. However, the wholesale prices of industrial commodities (that is, all commodities other than farm products and processed foods) continued to edge up in December (see Chart I); still, they ended the year only 1 per cent above December 1958. The consumer price index slipped 1/10 of a point in December, the first drop since August. Over the year as a whole, the consumer price index moved up 1.5 per cent, mostly because of increases in the prices of services.

#### THE NEW INDUSTRIAL PRODUCTION INDEX

A much refined tool for the analysis of United States business conditions was unveiled at the end of December with the publication by the Board of Governors of the Federal Reserve System of a thoroughly revised industrial production index. This is the third substantial revision of the index since it first appeared in 1927, and covers the period from January 1947 on. The changes are, in summary, as follows: (1) Electric and gas utility output has been added to the index, supplementing the output of manufacturing and mining industries. (2) The individual



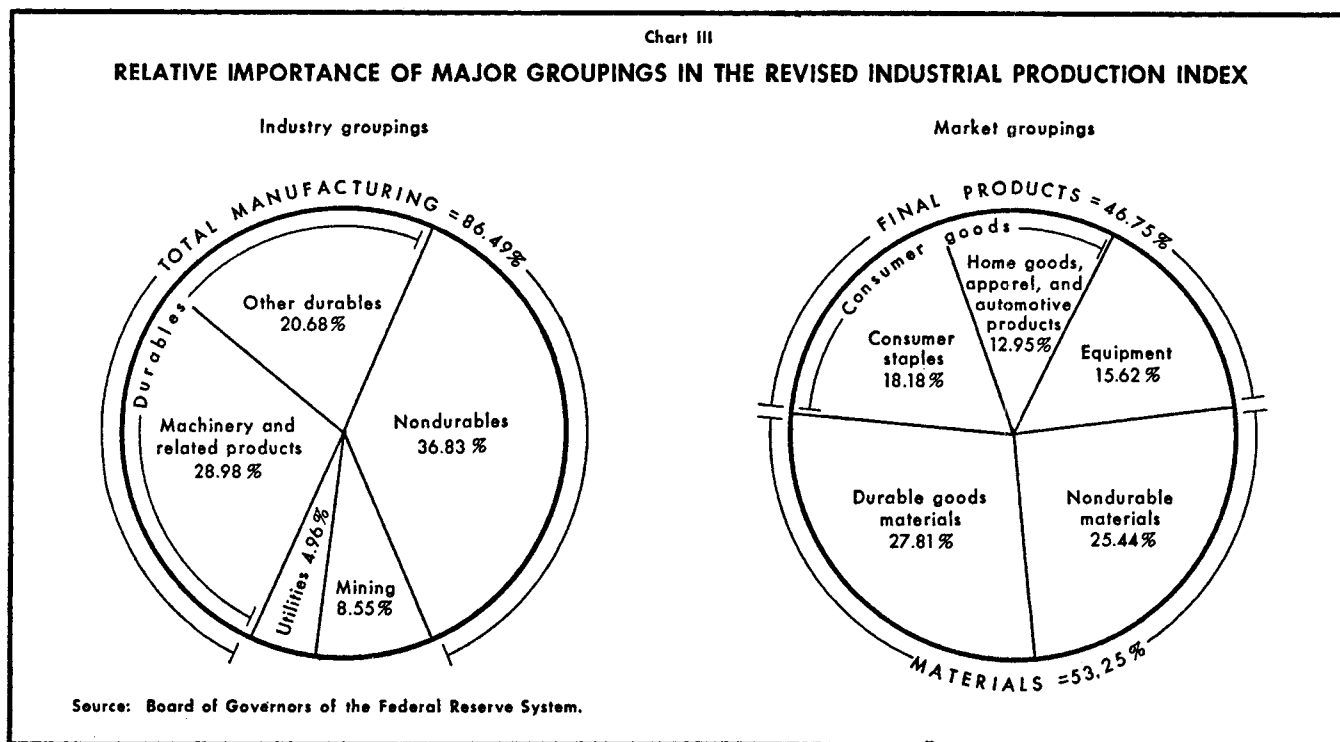
production series, formerly grouped only by "industry" (for example, primary metals and transportation equipment), are now grouped also according to "market"—the three most comprehensive categories being consumer goods, equipment (business and defense), and materials. (3) The series have been adjusted to take into account new data that show the production of individual items more accurately; these "bench-mark" figures have been obtained primarily from the detailed 1954 Census of Manufactures. (4) The estimating procedures have been refined for those series that, for lack of current physical output data, are based on man-hour data. (5) Some new monthly series have been added. (6) All seasonal adjustments have been revised. (7) The industry groupings have been reclassified to accord with the Bureau of the Budget's 1957 Standard Industrial Classification. (8) The weights for the combining of individual series into groups continue to be derived from 1947 "value added" relationships for the years 1947-52, but, for the years beginning with 1953, 1957 relationships are used. (9) The "comparison base" for all series is now 1957 rather than 1947-49, and the regularly published figures will have this base (i.e., 1957=100) pending general adoption of a new one by other Federal agencies. (However, the total index as well as major groupings will continue to be published for an indefinite period on a 1947-49 base also.)<sup>1</sup>

The effects of the revisions on the total industrial pro-

duction index are shown in Chart II for the years 1953 through 1959. (Prior to 1953, when the new value-added relationships were incorporated, the differences between the old and the new indexes were not so substantial as later on.) To facilitate comparisons, all three series in the chart are given on a 1947-49 base. The series are: (a) the old index, which covered only manufacturing and mining; (b) the revised index of manufacturing and mining only, which will no longer be compiled by the Board as a separate index, and (c) the new index, which covers manufacturing, mining, and utilities. It will be noted that in 1959 the new index reached a pre-strike peak of 166 in May and June, while the old index at its June peak was only 155. About two thirds of this gap between the two is attributable, as the chart shows, to changes in the old manufacturing and mining series, and about one third to the inclusion of electric and gas utilities.

From the new index it now appears that production in the United States since 1947 has risen at an average annual rate of 4.1 per cent, significantly faster than the previously assumed rate of 3.8 per cent. These rates of course lump

<sup>1</sup>The December 1959 *Federal Reserve Bulletin* presents the new series of total and summary groupings back to January 1947 on both a 1957 and a 1947-49 base. More detailed historical series will be presented by the Board of Governors in a separate publication. While current figures for the total index and for the major industry and market groupings will be available in current issues of the *Bulletin*, the only published source of all the individual series will henceforth be the Board's midmonthly *Business Indexes* release.



together years of rapid growth and years of slower growth and conceal the important swings that reflect cyclical variations in economic activity.

The revised figures show slightly greater fluctuations in recent years than was indicated by the old index. The upswing from 1954 to 1957 is 1 per cent more in the revised manufacturing-mining index than in the old index; the 1957-58 dip is 2 per cent more; and the rise from the spring of 1958 to the months just before the recent steel strike is almost 4 per cent more. When utilities are added, the fluctuations are similarly greater than before. The principal reason for these wider fluctuations is the shift from 1947 to 1957 value-added relationships, which gives greater weight to items whose prices rose relative to others between 1947 and 1957. And prominent among these were automobiles, steel, and machinery, all of which are especially sensitive to cyclical fluctuations.

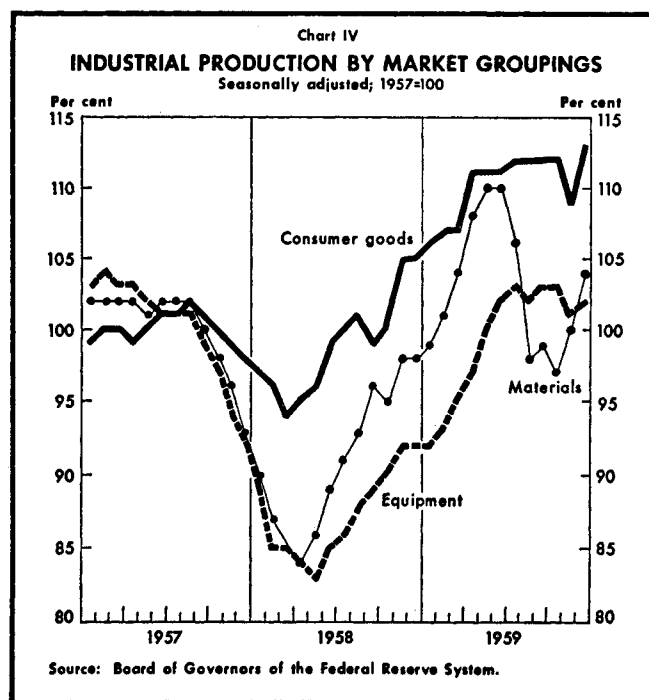
The inclusion of utilities output in the total index, in order to have a better representation of fuel and power production, has naturally reduced somewhat the weight of manufacturing and mining. Previously, manufacturing accounted for 90 per cent, and mining for the remainder; now, manufacturing accounts for 86½ per cent, and mining for 8½ per cent, while utilities are assigned 5 per cent (see Chart III). Even more important have been the changes within the manufacturing sector itself. In the old index, nondurables and durables were given almost exactly the same weights. Now, however, durables account for 50 per cent of the total as against 37 per cent for nondurables. The gain of durables over nondurables reflects largely the growing importance of aircraft manufacturing, and the growth in metals and industrial and commercial machinery—items whose prices, as indicated earlier, rose substantially more than average. The change in weight for these products has pushed up the “machinery and related products group” from 51 per cent of the total durables group to 58 per cent, i.e., to 29 per cent of the total new index.

Before the index was reconstructed, the only “market” index published by the Federal Reserve Board was a limited, special “consumer durables goods” index. Now, however, all the series included in the industrial production index are classified according to market. The major categories may be seen in Chart III. The “final products” sector consists of (a) consumer goods and (b) business and defense equipment, and accounts for somewhat less than one half of the total new index (47 per cent), with consumer goods about twice as important as equipment. The other 53 per cent of the total new index is made up of “materials” and is divided almost equally between nondurables and durables. The individual series of the con-

sumer goods sector are also being compiled in two alternative groups, different from those shown on the chart. One group includes the cyclically sensitive automotive products and home goods—appliances, furniture, and other durables—(7.75 per cent), and the other the less sensitive apparel and staple goods (23.38 per cent). Aside from these last two groups, the market breakdowns distinguish among a total of forty-seven major groups and subgroups.

With this amount of detail, important and sometimes critical economic developments can probably be spotted somewhat earlier than was heretofore feasible, and analyzed in greater depth. For instance, inventory movements of the sort mentioned earlier, in the discussion of current developments, can be a significant cyclical factor. The market groupings may facilitate an evaluation of movements in materials inventories by permitting fluctuations in materials output to be measured against fluctuations in the output of consumer goods and equipment; and a sharper rise in the former than in the latter could suggest that materials inventories are being accumulated. However, some estimate would have to be made of leakages into, for instance, exports and construction. The accumulation (or liquidation) of specific categories of materials inventories could perhaps be similarly examined by utilizing subgroups. The market groupings also permit growth patterns in different types of goods to be explored.

Comparison of the fluctuations in the consumer goods,



equipment, and materials indexes during the past three years shows that, over the period, the consumer goods index rose the most and that during the 1957-58 recession it fell the least (see Chart IV, in which 1957=100). The 1957-59 rise reflects primarily the secular increase in population, as well as the growth, over the period as a whole, in disposable income. The dip during the recession was less than in the other sectors, largely because the consumer goods index is heavily weighted by food, other consumer staples, and apparel, all of which are less sensitive to short-run changes in income than are consumer durables and the equipment and materials sectors. As regards the other two indexes, the equipment index shows only a slightly sharper dip than materials in 1957-58, but a substantially less sharp rise than materials in 1958-59.

The latter relationship is in part attributable to the usual lag in demand for business equipment when a cyclical recovery begins. It also reflects, however, the rapid accumulation of primary metals inventories during the first half of 1959, undertaken in anticipation of the midyear steel and copper strikes. The sharp impact of the strikes on materials output is revealed in the steep drop of the materials index during the third quarter of 1959; and the subsequent curtailment in output of consumer goods and equipment that resulted from the ensuing materials shortages is also evident. The closing months of the year, on the other hand, show the pickup in materials production that followed the reopening of the steel mills in early November, and the positive influence this had on the output of final products in December.

### Money Market in January

The money market continued tight during January, although seasonal repayment of bank loans and large flows of nonbank funds into the market relieved the severe pressure on short-term interest rates that had characterized the closing weeks of 1959. Reserve positions of member banks remained under pressure, as large seasonal reserve gains were offset by System open market operations. The effective rate on Federal funds held firmly at 4 per cent on most days of the period, and rates on new and renewal loans to Government securities dealers at the New York City banks rose from a flat 5 per cent at the end of December to 5¼-5½ per cent at midmonth, before declining to a uniform 5 per cent in the closing days of the period.

As often happens at this season of the year, yields declined during January in the Government and other securities markets. Treasury bill rates moved markedly lower over the month, as strong demand from nonbank investors encountered an increasing scarcity in the market supply of most issues of bills despite sizable sales and redemptions of these obligations by the System. The decline in rates, which was also evident in the market for Treasury notes and bonds, may also have reflected a number of loosely related background factors—reaction to the sharp rise in yields of the previous two months, the forecast of a sizable budget surplus for fiscal 1961, and the emergence of a feeling in the market that, contrary to earlier expectations, interest rates might not move further upward in the period ahead. There also were re-

ports that the market for notes and bonds was strengthened by some movement of funds out of equities, which in turn may have been related to the sharp decline in stock prices during the month.

The Treasury announced on January 28 that it would offer 4⅞ per cent one-year certificates to mature February 15, 1961 and 4⅞ per cent four-year nine-month notes to mature November 15, 1964, in exchange for \$11,363 million of 3¾ per cent certificates maturing February 15, 1960 and \$198 million of 1½ per cent notes maturing April 1, 1960. The certificate will be offered at par, while the new 4⅞ per cent note is to be offered at 99.75 per cent of face value, making the effective yield about 4.93 per cent. The subscription books for the exchange will be open from February 1 to February 3.

#### MEMBER BANK RESERVES

Net borrowed reserves of all member banks averaged \$416 million for the four statement weeks in January, little changed from the \$444 million average for the five statement weeks ended in December. Average excess reserves were virtually unchanged at \$487 million, and average borrowings at the Federal Reserve declined by \$26 million to \$903 million. The relative stability of the average level of net borrowed reserves, however, concealed large movements in the individual factors affecting reserves. The major source of reserves was the usual January return of currency to the banking system following the large increase in circulation during the Christ-

mas shopping season. The total return flow in January amounted to \$1.2 billion, a volume somewhat greater than the net increase in currency in circulation during the entire second half of 1959. In addition, average required reserves declined, also seasonally, by \$407 million over the period. On a week-to-week basis, fluctuations in float were an important factor, absorbing reserves during all but the third week, when a substantial amount of reserves was provided by float.

Member banks also gained reserves in January as a result of the interest payment to the Treasury on Federal Reserve notes—statistically reflected in a decline in Federal Reserve capital and surplus accounts which are included in the item "other deposits, etc." shown in the table. The fact that the payment was larger than usual reflected a System decision to close out certain reserves for contingencies, to reduce the surplus accounts of the Federal Reserve Banks to 100 per cent of subscribed capital, and to pay the Treasury 100 per cent of net earnings. In effecting this new policy, the Reserve Banks transferred to the Treasury all the surplus in excess of subscribed capital as of December 31, 1959. Heretofore,

the practice had been to add approximately 10 per cent of the annual net earnings of the Federal Reserve Banks to the surplus accounts and to pay 90 per cent of the annual net earnings to the Treasury.

System open market operations during the month were employed to offset the gains through regular market factors. Reserves were absorbed in each week of the month, with the absorption reaching a peak in the third week when the midmonth increase in float combined with movements in other market factors to provide an unusually large amount of reserves. System open market activity tapered off in the final statement week, however, as the release of reserves through market factors abated somewhat. System holdings of Government securities were reduced by about \$1.3 billion from December 30 through January 27, as a result of \$1.3 billion of net sales and redemptions from the System Open Market Account and a \$30 million decline in securities held under repurchase agreements. The reduction in System holdings was at record proportions for this period, falling only slightly short of the postwar peak for January set in 1957.

#### GOVERNMENT SECURITIES MARKET

A sharp decline in Treasury bill rates and a parallel, if somewhat less pronounced, decline in note and bond yields were the striking features of the Government securities market during most of January. The rally, which began to gather momentum late in the first week of the month, seems in part to have represented a reaction to the pronounced rise in rates and decline in prices of the previous two months, which in many cases had carried yields to postwar highs and prices to postwar lows. While the market generally expected further economic expansion and strong demands for credit, there apparently was some feeling that these developments might not exert further strong upward pressures on yields, at least over the short run. The market, moreover, was buoyed by the President's statements in the State of the Union Message, and re-emphasized in the Budget Message, concerning the expectation of a large budget surplus in fiscal 1961.

Against this background, the appearance of a broad and sustained seasonal reinvestment demand for Treasury bills on the part of corporations, public funds, Government agencies, and other nonbank investors had a pronounced impact on market rates of interest. The market not only readily absorbed the sizable reduction in System and commercial bank bill holdings during this period, but the market supply of most issues rapidly diminished. Over the month, rates on most issues declined by 30 to 60 basis points, thereby erasing much of the increase of the previous two months.

Changes in Factors Tending to Increase or Decrease Member Bank Reserves, January 1960  
(In millions of dollars; (+) denotes increase, (-) decrease in excess reserves)

Factor	Daily averages—week ended				Net changes
	Jan. 6	Jan. 13	Jan. 20	Jan. 27	
<b>Operating transactions</b>					
Treasury operations*	- 64	+ 67	+ 12	- 26	- 11
Federal Reserve float	- 202	- 317	+ 244	- 410	- 685
Currency in circulation	+ 374	+ 237	+ 372	+ 260	+ 1,243
Gold and foreign account	+ 39	+ 39	+ 77	+ 13	+ 168
Other deposits, etc.	+ 132	+ 224	+ 10	- 6	+ 360
<b>Total</b>	<b>+ 280</b>	<b>+ 250</b>	<b>+ 714</b>	<b>- 169</b>	<b>+ 1,075</b>
<b>Direct Federal Reserve credit transactions</b>					
Government securities:					
Direct market purchases or sales	- 180	- 268	- 719	- 170	- 1,337
Held under repurchase agreements	- 7	+ 21	- 54	- 2	- 42
Loans, discounts, and advances:					
Member bank borrowings	+ 85	- 102	+ 3	- 141	- 155
Other	-	- 1	-	- 1	- 2
Bankers' acceptances:					
Bought outright	-	-	+ 1	- 3	- 2
Under repurchase agreements	- 5	- 19	- 10	-	- 34
<b>Total</b>	<b>- 109</b>	<b>- 368</b>	<b>- 779</b>	<b>- 318</b>	<b>- 1,574</b>
<b>Member bank reserves</b>					
With Federal Reserve Banks	+ 171	- 118	- 65	- 487	- 499
Cash allowed as reserves	- 55	+ 6	- 29	- 22	- 100
<b>Total reserves</b>	<b>+ 116</b>	<b>- 112</b>	<b>- 94</b>	<b>- 509</b>	<b>- 599</b>
Effect of change in required reserves†	- 92	+ 171	+ 102	+ 226	+ 407
<b>Excess reserves†</b>	<b>+ 24</b>	<b>+ 59</b>	<b>+ 8</b>	<b>- 283</b>	<b>- 192</b>
<b>Daily average level of member bank:</b>					
Borrowings from Reserve Banks	1,013	911	914	773	903‡
Excess reserves†	509	568	576	293	487‡
Net borrowed reserves†	504	343	338	480	416‡

Note: Because of rounding, figures do not necessarily add to totals.

\* Includes changes in Treasury currency and cash.

† These figures are estimated.

‡ Average for four weeks ended January 27, 1960.

The improvement in the Treasury bill market was also evident in the success of the Treasury's financing operations in January. The first phase of the operation, the auction on January 5 of an additional \$2 billion of June 22 tax anticipation bills, brought out strong bidding by the commercial banks, which could make payment for the bills through credits to Tax and Loan Accounts. The average issuing rate for these bills was 4.726 per cent, a rate considerably below the market, which reflected the advantage to commercial banks of being able to pay for the bills through credits to Treasury deposits on their books. The bills began to trade on the secondary market at 5.12 per cent bid, but by the end of the month the market rate had declined to 4.48 per cent.

The second phase of the financing—the auction on Tuesday, January 12, of \$1.5 billion 366-day Treasury bills to replace the major part of the \$2.0 billion of maturing January 15 bills—elicited considerable enthusiasm from the market generally, and in some areas from small investors in particular whose interest had been stimulated by press comments over the week end. The average issuing rate of 5.067 was well below the 5.25 per cent or higher that many market observers had expected only a few days earlier. A good demand for these bills subsequently developed, and the market rate moved down to 4.74 per cent by the end of the month. The stronger tone of the market was also evident in the last three regular weekly bill auctions. Average issuing rates declined in each of these auctions, with the rate in the January 25 auction at 4.116 per cent for 91-day bills, or 55 basis points less than the record rate established in the December 21 auction, and at 4.608 per cent for 182-day bills, or 49 basis points below the record 5.099 rate in the January 4 auction. At the end of the month, the three-month bills were trading in the market at 3.99 per cent, and the six-month bills at 4.46 per cent.

Prices of Treasury notes and bonds moved irregularly upward through most of January, with the rise over the month generally ranging from  $\frac{1}{4}$  to  $1\frac{1}{4}$  for notes and short-term bonds, and from  $\frac{1}{2}$  to  $2\frac{1}{4}$  for longer term issues. By the close of the period, the average yield on long-term bonds had declined to 4.34 per cent, compared with 4.39 per cent at the end of December, while the average yield on issues due in three to five years had dropped to 4.77 per cent, about the level prevailing in mid-November. The market was favorably affected by the sharp decline in stock prices that occurred after the first week of the month, and which apparently reflected in part some shifts of funds from the stock market. In addition, press reports of discussions in Congress of possible action that would permit advance refunding of outstanding bond

issues also tended to strengthen the  $2\frac{1}{2}$  per cent "tap" bonds, issues frequently mentioned as candidates for advance refunding, without depressing longer term issues. Demand for the most part remained limited, however, originating principally with small investors and with professionals for the purpose of covering short positions, and the volume of trading generally remained small.

#### OTHER SECURITIES MARKETS

A moderate upward trend developed in prices of seasoned corporate and, especially, in tax-exempt securities during January, reflecting the same underlying factors that affected the Government securities market. The average yield on Moody's Aaa corporate bonds held at 4.61 per cent throughout most of the period, but the similarly rated tax-exempts declined to 3.47 per cent at the month end, 2 basis points below the end-of-December level.

During January, the flotation of new corporate bonds and tax-exempt securities rose substantially above the seasonally low December levels. New tax-exempt flotations aggregated \$625 million, an increase over both the December amount of \$394 million and the January 1959 total of \$547 million. The new issues met with receptions ranging from fair to excellent. Among these issues was an offering by a State power authority of \$96 million of  $4\frac{3}{8}$  per cent term bonds due in 2006 and priced at par, and a companion issue of \$24 million of 4 per cent and  $3\frac{3}{4}$  per cent serial bonds due 1965-79. The term bonds were sold at a net interest cost of 4.388 per cent, with the serial bonds reoffered at yields ranging from 3.50 to 4.00 per cent. Another State issue of \$100 million (Aa-rated) bonds was sold at a net interest cost of 4.02 per cent and was reoffered to yield from 3 to 4 per cent. This issue was originally scheduled to be sold in December but had been postponed. New corporate issues marketed during the month totaled \$324 million, an increase over the \$258 million in December but slightly less than the January 1959 figure of \$376 million. Most corporate issues were accorded fairly good receptions. The market for United States Government agency obligations was also firm over most of the period. New issues, which aggregated a sizable \$651 million, were very well received, generally at slightly lower offering rates than in the latter part of 1959.

Rates on several short-term money market instruments were adjusted upward early in the month but most were subsequently lowered in the latter part of the period. On January 6 and 7, the New York banks raised the rates on call and time loans secured by customers' stock exchange collateral to  $5\frac{1}{2}$  per cent from 5 per cent. On January 8, sales finance company rates on directly placed paper were



raised by  $\frac{1}{8}$  to  $\frac{3}{8}$  of a percentage point, with 60- to 89-day paper  $\frac{1}{8}$  per cent higher at  $4\frac{3}{4}$  per cent. However, these companies cut rates by  $\frac{1}{4}$  to  $\frac{1}{2}$  per cent on January 27 and at the same time combined the 30- to 59-day and 60- to 89-day maturities into a 30- to 89-day maturity with a rate of  $4\frac{1}{4}$  per cent. Rates on commercial paper, which were advanced  $\frac{1}{8}$  per cent on January 11 to bring the offered rate on prime 4- to 6-month paper to 5 per cent, were reduced by the same amount on both

January 22 and January 27, thus lowering the rate to  $4\frac{3}{4}$  per cent. Dealers in bankers' acceptances increased all rates by  $\frac{3}{8}$  per cent on January 7 and 8, making the new bid rate on 90-day unindorsed paper 5 per cent. But on January 21, one dealer lowered the rates on all paper by  $\frac{1}{8}$  per cent with the 90-day maturity at  $4\frac{7}{8}$  per cent. On January 29, four acceptance dealers reduced rates on all maturities by  $\frac{1}{4}$  per cent and one dealer by  $\frac{1}{8}$  per cent, with the 90-day maturity at  $4\frac{3}{4}$  per cent bid.

## International Developments

### NEW MOVES IN INTERNATIONAL ECONOMIC COOPERATION

The recent establishment of the Inter-American Development Bank and the moves now under way to broaden the Organization for European Economic Cooperation are significant steps toward greater cooperation in seeking solutions for international economic problems. Although many formal and informal regional economic groupings have emerged since the end of the war, the two arrangements now being launched are the first of their kind in which the United States would be a full participant.

**THE INTER-AMERICAN DEVELOPMENT BANK**, which became a legal entity on January 1, climaxes more than half a century of attempts to establish an inter-American financial institution. In recent years, with the drive for economic development and for the creation of a regional market gaining momentum in Latin America, the idea received general acceptance and, in November 1958, a special committee of the Organization of American States began formulating a draft charter. In April 1959 this charter was signed, and by the end of the year it had been ratified by eighteen of the twenty-one signatories, including the United States.

The objectives of the new institution are to promote the general economic development of Latin America and its economic integration, to provide technical assistance to member countries in the formulation of development programs and the establishment of project priorities, and to encourage the flow of private capital to the area. The institution will have total capital resources of \$1 billion, of which the United States contribution will be \$450 million. These resources will be supplemented with funds obtained by the flotation of the institution's own securities. The Inter-American Development Bank will consist of the

bank proper and a fund for "special operations". The bank will conduct "ordinary operations", on the basis of member capital subscriptions totaling \$850 million. These operations will consist of loans for specific projects repayable in the currency in which they are made. The loans may be extended to cover both the foreign exchange and the local currency requirements of the investment projects. The bank will not necessarily require a government guarantee on loans extended to nongovernmental entities. The special fund, financed with resources derived from additional member contributions (\$150 million, of which the United States will contribute \$100 million), will extend loans partially or wholly repayable in the currency of the country in which the project is located. These loans are intended to finance undertakings that may not contribute directly to the borrower's foreign exchange earning capacity, presumably "social overhead" projects, such as health and research centers, schools, and similar facilities.

Although the institution's \$1 billion capital stock is a sizable sum, only a part will be available for lending when actual operations begin. On the basis of full membership, the bank's paid-in capital for ordinary operations will total \$400 million, the unpaid capital of \$450 million serving as a guarantee fund for the flotation of the bank's own securities. Of the paid-in capital, 20 per cent is to be paid immediately, together with 50 per cent of the separate contributions to the fund for special operations. The remainder of the payments to both the bank and the fund will be made over a period of two to three years. The statutes further specify that only half of each instalment is to be paid in gold or dollars, the rest being payable in the members' own currencies.

The structure and organization of the bank closely resemble those of the International Bank for Reconstruction and Development. Formulation of policy rests with

a board of governors, on which each member country has representation. A seven-man board of executive directors, including one designated by the United States, constitutes the bank's highest executive organ. Administration of the bank's operations is under the authority of a president, elected by the governors. The election of the president and the setting-up of the two governing bodies is scheduled for the bank's organizational meeting in El Salvador this month. Policy decisions by the governors and by the executive directors will be made on the basis of votes weighted according to size of capital subscriptions, and will be by simple majority of the total votes cast.

The Inter-American Development Bank is intended to supplement, rather than to replace, existing sources of development finance in Latin America. Hence, effective coordination of its lending activities with those of other agencies is regarded as vital to the institution's success. At least initially, a sizable part of the bank's operations is expected to take the form of participation in, or guarantees of, loans extended by other lenders. For the longer run, there is general agreement that the bank's capacity to meet the rising financial requirements of the region will hinge on its ability to tap the world's private capital markets. This of course requires that the bank's ordinary operations be conducted on the basis of sound banking principles and in a manner that will inspire confidence among prospective investors. With regard to the bank's special operations, concern has been expressed that the granting of loans repayable in the borrower's currency may result in sizable holdings of national currencies with limited international usefulness. It is hoped, however, that the strengthening of the Latin American economies will gradually reduce the need for loans from the special fund, while the growth of intraregional trade will at the same time steadily widen the scope for employing national currencies.

**PROPOSAL FOR A NORTH ATLANTIC COMMUNITY.** While United States participation in the Inter-American Development Bank reflects this country's concern with economic growth in this hemisphere, the recent proposal by the United States to broaden economic cooperation within the North Atlantic community would forge an important new link with Western Europe. The need for such a link arises from several factors. First, the formation of the European Common Market and the European Free Trade Association threatens to split the area in two distinct trading zones, which may inhibit effective economic cooperation in Western Europe. Second, the United States balance-of-

payments deficit during the past two years has emphasized the need for a more active role by the United States in promoting freer trade and safeguarding the recent advances in the direction of multilateralism. And, third, the restoration of Western Europe's economic strength has opened the way for a cooperative approach to the channeling of aid to the economically underdeveloped regions.

Against the background of these considerations, the United States proposed on January 12 that the eighteen-nation Organization for European Economic Cooperation be broadened into an economic body in which the United States and Canada would participate as full members. Representatives of the twenty governments concerned are to meet in Paris on April 19 to consider arrangements for achieving this objective. A committee of four has been named to study the problem in the meantime, and to submit a report which will facilitate the work of the April 19 meeting. In addition, eight countries (the United States, Canada, Britain, France, West Germany, Belgium, Italy, and Portugal) have set up an informal body for the purpose of exploring techniques to facilitate the flow of long-term funds to underdeveloped areas.

The proposal for the establishment of an economic organization capable of dealing effectively with North Atlantic community trade problems and with the question of sharing the development-aid burden raises many issues that cannot be solved quickly. Nevertheless, within the Atlantic community, just as within the Western Hemisphere, important steps have now been taken to establish a new basis for international economic cooperation adapted to the changing positions of the various countries and regions in the world economy.

#### EXCHANGE RATES

Spot and forward sterling quotations tended to ease slightly in the first half of January in a quiet market. Following the announcement of the increase in the Bank of England's discount rate from 4 to 5 per cent on January 21, the spot quotation firmed to \$2.8028, while the forward quotations, which had commanded rather substantial premiums, abruptly dropped to par with the spot rate. At the end of January spot sterling was \$2.8027, while three and six months' forwards had moved to discounts of 2 and 4 points, respectively. The Canadian dollar moved somewhat erratically between \$1.04 $\frac{2}{3}$  $\frac{1}{2}$  and \$1.05 $\frac{1}{6}$  $\frac{1}{4}$ , and was quoted at \$1.05 at the month end.

## Comments on Employment, Growth, and Price Levels

By WILLIAM MCCHESENEY MARTIN, JR.\*

*Chairman, Board of Governors of the Federal Reserve System*

We have been most impressed with the fine work that the Joint Economic Committee and its staff have been doing, during the course of the Study of Employment, Growth, and Price Levels, in bringing together the thinking of qualified persons, in formulating questions to be addressed to us and to other agencies, and in the studies thus far published.

In reading over the material that has been presented to the Committee, it occurs to me that there are two aspects of the problems under study that may deserve more explicit consideration than has been given to them so far.

The first point that I have in mind relates to imperfections in our price system—variously referred to as cost-pushes, ratchet effects, and administered prices—and perhaps it can best be phrased in the form of a question. Granting that there are these imperfections as regards the behavior of individual prices and that they create inflationary pressures or biases in economic processes that cannot be effectively dealt with by monetary policy, does it follow from this that monetary policy should be less (or more) restrictive than if such phenomena did not exist? I am sure that all serious students of economic policy are concerned with this question and, to some extent, their views are implied in their responses to other questions. I know this is true, for example, in the case of much of the material which the Federal Reserve has furnished to the Committee.

As I understand it, the argument presented by those who advocate acceptance of creeping inflation is that institutional factors which are not dealt with directly by Government action are likely to cause money wages and administered money prices in certain basic industries to increase more rapidly than is consistent with full employment of the labor force and the growth of other productive resources. Therefore, unless these wages and prices are, in effect, reduced by inflating the price of everything else, we will suffer from chronic underemployment. In other words, these advocates suggest that monetary and, indeed, fiscal policy as well, should be used openly to frustrate the

bargaining efforts of organized labor and the pricing policies of certain industries. Only in this way, they imply, can a workable equilibrium be achieved between the marginal productivity of labor and real wages and between the relative prices of competitively marketed and administered price goods.

The objections to a policy of deliberately engineered creeping inflation seem to me to be manifold. I hope the problems generated by such a policy, with respect to the whole process of saving and investment and for the balance of payments, have been adequately treated in my responses, and those of others, to the questions asked by the Committee. If this is the case, all that needs to be said here is that these problems would be greatly intensified by any effort to absorb wage increases and administered prices through calculated inflation.

Beyond this, I think there is a very serious question as to whether such a policy could possibly succeed in the accomplishment of its primary objective. Would those who are in a position to administer prices or extract wage settlements in excess of productivity gains be content to maintain the same pace when they discovered that their efforts to capture a larger share of the real income stream were being frustrated by calculated inflation? Would they not increase their demands further to improve their relative position?

Thus, it seems probable that, far from encouraging a high level of employment and growth in the economy, a policy of calculated creeping inflation would not make any contribution—and certainly not a lasting one—toward the correction of the difficulties toward which it was directed. On the contrary, it would involve all of the social injustices that economists universally agree accompany inflation, and it would also disrupt the saving and investment process, which must function efficiently if vigorous growth and high level employment are to be sustained.

If we reject a policy of deliberate inflation, what should be the role of monetary policy in a situation in which the over-all price level or average of prices is being pushed up by administered costs and prices? Increases in the general level of prices, and the expectation of further increases, regardless of their origin, diminish the incentive to

\* Substance of a letter sent to Senator Douglas, Chairman of the Joint Economic Committee of the Congress, by Chairman Martin on December 9, 1959.

save and increase the incentive to borrow. Hence, unless credit expansion is limited to a rate of growth consonant with the increase in the physical output of goods and services a cost-push inflation will automatically become a demand-pull inflation as well. This point is spelled out in one of the papers I referred to in my replies to the Committee, but I would like to quote it in this context.

"It is the fact of rising prices or anticipation of rising prices that provides the incentive to borrow to finance overaccumulation of inventories and the construction of plant capacity in advance of need. It is the fact of rising prices or the anticipation of rising prices that leads to misallocations of investment and miscalculation of investment decisions. It is rising prices or the anticipation of rising prices that diverts savings into equities, and that dissipates their ability to finance growth, in short, that diminishes the supply of loanable funds and accentuates the demand in such a way as to force high and rising interest rates. Finally, it is the fact that a country's prices have risen above those of its competitors that prices a country out of world markets and initiates a deficit in the balance of payments. All of these reactions, which place great strains on the monetary and fiscal mechanism, ensue irrespective of whether an inflation may be described as cost-push or demand-pull.

"In the credit market, these situations increase the profitability of operating on borrowed funds even at very high interest costs. They increase, therefore, the demand for borrowed funds far above the amounts made available by savings and unless they are resisted by appropriate fiscal and monetary policies, i.e., by balanced budgets and by restraints on the availability of reserves, they result inevitably in an expansion of bank-created money.

"Because borrowing to anticipate inflation appears very profitable, the pressure of customers on their banks to borrow is very heavy and this in turn brings pressure on the Federal Reserve Banks to expand reserves. If this pressure is resisted, interest rates may have to rise quite sharply before the force toward overexpansion is contained. If the pressure is not contained and bank-created money is used to finance these hedges against inflation, the inflation, even if it started as a cost-push type, will by that very fact be converted into one of the demand-pull variety."

This indicates how the pressure of cost-pushes on price levels leads to conditions in which monetary policy tends to be forced into a more restrictive position than would otherwise be the case and the level of interest rates tends to be higher than would otherwise be required to maintain the balance between savings and investment. On the one hand, it gives strong support to the desirability of direct

and vigorous attack on cost-push elements themselves. On the other hand, it suggests to me that the adoption of a "stable plus cost-push" goal for prices could not lead to anything but trouble. It would both encourage the proliferation of cost-pushes and, at the same time, provide the demand-pull to match them. We come back to what appears to me the inescapable conclusion that deviation from the objective of reasonable price stability for all arms of public economic policy would multiply our difficulties, not reduce them.

The second, and related question which I think deserves more examination and probing, might be stated as follows: Does the demand for credit from consumers and for private investment sometimes converge on the market with such vigor that it defies any reasonable application of general monetary and fiscal measures, producing either uncontrollable inflationary forces or the impoverishment of certain socially desirable programs which are unable to compete for loanable funds, and perhaps having both effects? If this happens, should an attempt be made to expand bank credit sufficiently to satisfy all credit-worthy borrowers at a lower rate of interest than the demand and supply relationship between real savings and investment would establish? This sort of surge in the demand for credit in the private sector, it is argued, presents a problem not unlike that to be faced should the Federal Government be required to expand its expenditures and borrowing rapidly in a defense emergency. The implication is that bank credit expansion—a form of forced saving through inflation—is the only way to meet this problem so as to prevent socially undesirable distortions in the economic system.

To me, this line of reasoning is indefensible, on both moral and economic grounds. To the extent that such a program could succeed, even temporarily, it could do so only because the public was deceived as to the nature of the policy and its effects. The moral objection to any national policy based on public deception seems to me overwhelming. On economic grounds, this kind of monetary policy could not possibly succeed for more than a very short period. Even before the economic effects became fully apparent, they would be anticipated by those who would seek to protect themselves from the ravages of inflation, or to profit from it. The inevitable result would be a rapid decline in the volume of savings and an even more rapid rise in the rate of interest than would otherwise have occurred.

Rather than inflation, the first approach to a solution to this problem lies in a sound general monetary and fiscal policy. Of equal importance is the elimination of those imperfections in the operation of the price and wage mech-

anism mentioned in connection with my first point. If we do these things I believe there is a strong likelihood that we will avoid the kind of surges of credit demand that are postulated. If they still occur then we should certainly consider the application of selective controls on credit use by consumers and businesses. I would like to hope that these can be avoided because I am sure that they are bound to interfere with the process by which resources are directed to their most efficient uses in a free enterprise economy. When one weighs the alternatives, it seems clear that such controls would be preferable to either calculated or uncontrolled inflation, but we should recognize that they involve a degree of regimentation never before accepted in this country except in time of war.

I have addressed myself to these questions at some length because I think there may have been some real misunderstanding of my position. My interest in a monetary policy directed toward a dollar of stable value is not based on the feeling that price stability is a more important national objective than either maximum sustainable growth or a high level of employment, but rather on the reasoned conclusion that the objective of price stability is an essential prerequisite to their achievement.

I want to emphasize that I am most concerned with the

preservation of freely competitive markets and the correction of any institutional imperfections which exist in the working of the price mechanism. While such imperfections cannot be corrected simply by a sound monetary and fiscal policy, they surely cannot be corrected by an unsound financial policy.

Nor does a sound general monetary policy necessarily, in itself, accomplish the optimum distribution of loanable funds among various sectors of the economy. It is not only the right but the duty of Government to assure that socially necessary programs are adequately financed. But, again, this objective can never be well served by unsound general monetary or fiscal policies. If, as a matter of public policy, the financing of school construction, for example, should have an overriding priority in the allocation of resources, this can be accomplished in a number of ways, but we can be sure that it would not be accomplished by the general expansion of bank credit and money.

I trust that these additional comments will be helpful to the Committee in its work of clarifying for the Congress and the nation the basic issues involved in attaining and maintaining optimum levels of employment and vigorous growth, as well as a structure and level of prices conducive to both.

### Growth and Price Stability: The German Experience

The postwar recovery of the West German economy and the country's return to a place among the great industrial nations have constituted one of the most impressive performances of the postwar economic scene. Despite heavy wartime destruction and the burdens of partition, plant dismantling, and refugees, Germany regained prewar production levels within five years of the end of the war and had become a pacesetter among Europe's most prosperous countries. Equally striking has been the great strengthening of the country's international economic position, which has turned the German mark into one of the world's hardest currencies. These achievements—to which massive United States aid of course contributed—were at least partly the result of the early restoration of a free market mechanism by which effort and resources could be channeled into their most useful employment. The early adoption of a vigorous monetary policy, which helped to contain inflationary pressures at home and thus to ensure Germany's ability to compete in world markets, helped provide the orderly financial setting necessary for rapid economic recovery.

As one of the architects of this policy has pointed out,

there are perhaps two principal lessons to be learned from the German experience.<sup>1</sup> The first is that currency stability can be achieved and preserved even under adverse circumstances. The second lesson—and to him a more significant one—is that a monetary policy firmly committed to currency stability not only does not conflict with rapid and sustained economic growth but indeed is essential to its achievement. The present article—the fifth in a series dealing with the problems of growth and inflation in various economic environments<sup>2</sup>—undertakes to examine the German experience since the 1948 currency reform.

#### FACTS AND FACTORS IN GERMANY'S ECONOMIC RECOVERY

Following the end of hostilities in May 1945, the German economy was in almost complete collapse, due both

<sup>1</sup> See Dr. Wilhelm Vocke, "The Future of the Dollar", supplement to *Monthly Review*, June 1959.

<sup>2</sup> Cf. *Monthly Review*: "Creeping Inflation", June 1959; "Growth Without Inflation in Britain", July 1959; "Inflation and Economic Development", August 1959; and "The French Stabilization Program", January 1960.

to physical destruction and to the complete disorganization of the country's economic life and political institutions. Industrial production was at a virtual standstill. Imports had ceased completely, except for food supplies brought in by the United States and the United Kingdom. Moreover, money had largely lost its usual functions. Labor and other income recipients insisted on being paid partly in kind, bartering the commodities they received against others that they needed. Most people had little inducement to earn more money than they required for buying their rations, the prices of which remained generally fixed at the prewar level. Even by early 1948, West German industrial production was still only 50 per cent of the 1936 level.

The monetary reform of mid-1948, which in introducing the Deutsche mark canceled approximately 90 per cent of the money supply, supplied the necessary condition for awakening the country's economy from this stagnation. Black-market and barter transactions disappeared overnight, and a genuine price system re-emerged. Most important, the cancellation of a large proportion of the excess money supply that had resulted from the war years restored incentives to work and save.

While the first three years following the monetary reform constituted the most spectacular phase of Germany's postwar recovery, it was during this period that the economic and financial policies, discussed below, faced their most crucial test. The ultimate success of the currency reform was not assured until after about six months, during which time the authorities had to struggle against sharp inflationary pressures, despite rapid advances in output. This was followed by a period, lasting until the spring of 1950, during which the advance slowed somewhat, prices fell, and unemployment rose rapidly. As a result of the Korean war, after mid-1950 the German authorities found themselves confronted with a period of rising prices for the second time in two years. This time, however, it was not domestic inflation that had to be controlled. It was the external deficit, generated by panicky purchases of raw materials at rising prices and financed through European Payments Union credit, that threatened to wreck Germany's precariously maintained balance. However, the problems of these early years were overcome successfully, and economic activity thereafter continued to advance along more normal lines.

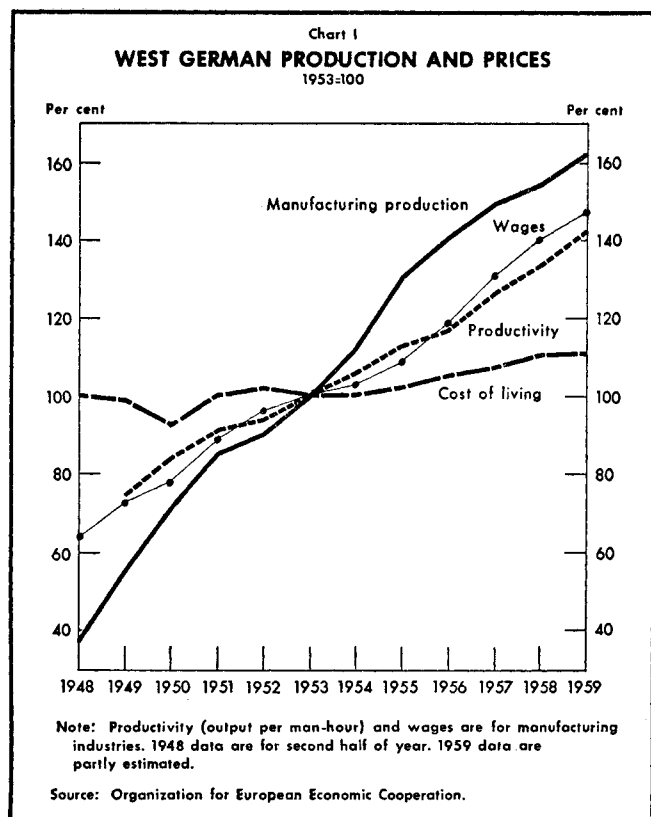
Despite the difficulties of the first few years following the monetary reform, in 1949-50 gross national product (GNP) increased by about 16 per cent per annum (at constant prices) and by the end of 1950 had regained its 1938 level. With the immediate needs of reconstruction met, the rate of growth slackened, but in the first half of the 1950's GNP still recorded annual increases of between 7 and 12

per cent. For the 1951-59 period as a whole, the average annual rate of increase of 9½ per cent was the highest for any country in Western Europe and North America; even in per capita terms, the annual increase in real GNP averaged about 8 per cent—a rate surpassed only by Austria. Industrial production registered even sharper gains, with an average annual increase of nearly 14 per cent for the 1951-59 period.

The extremely rapid advance in total production was based in part upon an exceptionally rapid increase in the labor force. In the first five years after the currency reform, the large-scale influx of refugees and the belated repatriation of prisoners of war swelled the total labor force by 21 per cent and created a serious unemployment problem. But by 1955 unemployment had been reduced to 5 per cent of the labor force and in 1959 to less than 2 per cent. Indeed, the average annual increase in employment over the whole 1949-59 period amounted to 4½ per cent.

The rapid expansion in total output also reflected a marked rise in productivity (see Chart I). During 1949-51, when the German industrial machine swung into high gear, output per man-hour in manufacturing rose by an average of over 10 per cent per year; in 1952-59, the advance still averaged 7 per cent. The particularly sharp productivity rise in the earliest years after the monetary reform reflected the simple fact that productive activity was being resumed in an economy that until then had been totally disorganized. More fundamental over the long pull was the high proportion of available resources channeled into investment. Throughout most of the postwar period the ratio of gross investment to GNP remained well above 20 per cent, substantially higher than for most Western European economies; this ratio has even risen somewhat further in the most recent years as a result of a marked rise in fixed investment. Germany was able in this manner to obtain a large increase in productivity in a short time. The process was helped further by the initial concentration of investment on projects of low capital intensity, and hence relatively quick returns, and on the replacement of destroyed or dismantled factories with the most up-to-date plant and equipment. The massive investment was facilitated by the relatively small share of GNP absorbed by the public sector thanks largely to the absence in the earlier years of a domestic defense establishment. It was also aided by fiscal measures that encouraged accelerated depreciation and ploughing-back of profits. Consumer spending, moreover, remained relatively low, in part apparently reflecting the desire of individuals to rebuild their assets.

Although the influx of refugees added to the demands



for resources, particularly for housing and related social capital, it undoubtedly served to moderate the pressure for wage increases. Labor's cooperative attitude also contributed to the process of rapid capital rebuilding by its restrained wage policy. The unions' relative emphasis on job security rather than on higher wages permitted wage increases to lag behind the rise in profits, and thus enabled business to utilize retained earnings for investment-financing on a large scale. The unions' sense of responsibility in assisting reconstruction and growth, buttressed by labor participation in management deliberations, was of course a major factor behind the relative stability of the Deutsche mark and helped to keep German exports competitive in world markets.

Labor's restraint did not mean that wage rates did not move up rapidly—the average annual wage increase in manufacturing amounted to almost 10 per cent during 1949-59. But the wage rise was not far out of line with the average increase in productivity (see Chart I). Partly as a result, the rise in the German price level has been one of the smallest in Western Europe—an average 1 per cent per year in 1949-59—and “real” wages advanced almost as rapidly as money wages.

An equally conspicuous facet of Germany's postwar economic recovery has been the sustained growth in German exports; Germany rapidly regained her prewar share of total world exports. During the past ten to twelve years, the generally high level of economic activity throughout the world and, for much of the period, the inflationary pressures in other countries have created a sellers' market for such German products as machinery, cars, and other highly specialized finished products. Moreover, most countries until fairly recently continued to discriminate against dollar imports and thus had to look for other sources of supply for many products. Germany offered such a source, especially as regards capital equipment. This factor was of considerable importance after Korea, when Germany's major trade partners started rearming, since Germany did not have to devote resources to the support of a defense establishment of her own and remained free, moreover, of economic and defense commitments toward overseas areas. German industry's aggressive export promotion, including active participation in international trade fairs, and great flexibility in adjusting its products to foreign requirements were also of course an important element in Germany's export performance.

#### THE POLICY FRAMEWORK

The encouragement of free enterprise in a free market has been the most widely publicized among the policies adopted by the German authorities to spur the country's recovery. While this policy never envisaged an economic system wholly free of government intervention (or, for that matter, of monopolistic practices), it did provide ample incentives to businesses and consumers alike. For the former, the absence of the detailed government regulation of the economy that characterized many other countries intensified both the opportunities and the pressures to improve industrial efficiency. Expansion of production was also facilitated by tax concessions which, as noted, were designed to stimulate private capital formation. In particular, tax benefits encouraged the self-financing of business through the use of profits and depreciation allowances; such funds financed as much as two thirds of new investment in the early part of the period. Tax incentives, as well as a system of government export credit insurance, also helped to spur exports. As regards the consumer, the free market policy assured him of the right to select freely among alternative products within the limits imposed by his earnings (after relatively low income taxes)—a fairly unique phenomenon in early postwar Europe. As a stimulus to personal effort, there was no attempt to discourage “conspicuous consumption” of luxury products by such

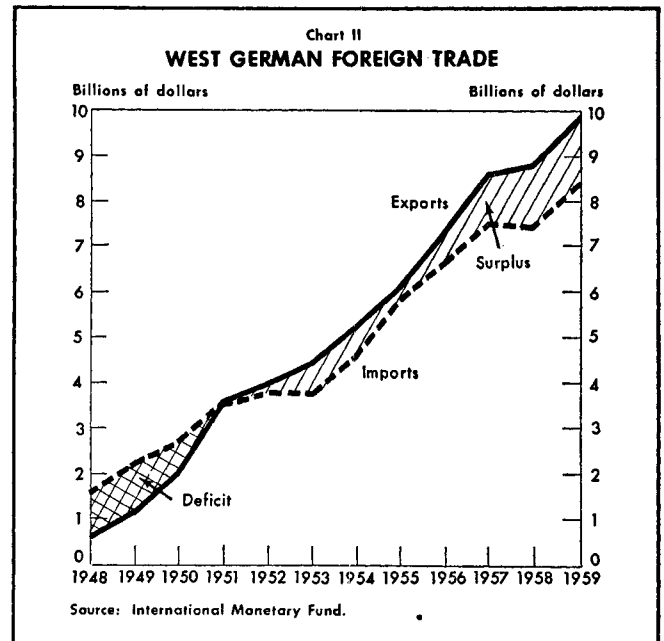
measures as high sales taxes or import restrictions. Nonetheless the rate of private savings was continuously high.

The policy of active competition and market freedom, which was applied domestically with such success, was also extended to foreign trade. Except in a few protected sectors like agriculture, from the immediate postwar years onward, increasing emphasis was placed on trade and payments liberalization. As a result, Germany was able at a relatively early stage to participate intensively in international trade (see Chart II), and to reap the benefits of international specialization. The absence of major trade restrictions probably would not have been possible, however, without the relative stability of the domestic price level. Indeed, the movement toward free markets and the policy of successively wider decontrol could have occurred only under conditions of relative price stability, which bolstered confidence in the mark. At the same time, of course, the climate of competition that was fostered by a minimum of government interference helped keep prices down.

While fiscal policy, through balanced budgets or budget surpluses, has provided a strong anti-inflationary assist, it was not used as a compensatory device for controlling fluctuations in economic activity. Monetary policy has been the principal official instrument for influencing over-all demand. The measures employed have been directed toward three general objectives. Price stability, in view of Germany's disastrous experiences with monetary inflation after two world wars, has received the highest priority. Next has been the provision of sufficient financing for the expansion of production. Finally, there have been the international objectives of increasing Germany's foreign trade in the early years of the period under review and, in the later years, of moderating the country's external surpluses. Within this framework monetary policy was conducted along fairly restrictive lines, although on a year-to-year basis the money supply was allowed to expand continuously. However, at the faintest signal of danger to internal price stability, the central bank was quick to apply its weapons of restraint.<sup>3</sup> The bank thus has resisted the temptation to aim at constant and unvarying full employment at the risk of inflation. In the over-all setting, the rapid growth of the German economy was sufficient to generate high employment.

While West Germany has been successful in reconciling rapid growth with a reasonable degree of price stability, it has been plagued with a balance-of-payments problem dur-

<sup>3</sup> The most recent example of this attitude was displayed last fall when the bank, after a "warning shot" in the form of a discount rate increase in early September, tightened its policy in order to keep the investment boom from getting out of hand.



ing recent years radically different from that faced by most other European countries. Germany's external surpluses and the accumulation of vast reserves have proved far more intractable than the temporary external deficit engendered by the inventory boom in 1950-51, which had led to energetic restrictive steps. And, although the central bank's policy in 1957-59 was directed toward lowering the over-all interest rate structure in order to promote, among other things, capital exports, this specific objective was subordinated when it no longer coincided with the need for some easing of credit at home. In once more moving toward higher interest rates in the closing months of 1959 the central bank, according to its president, "deliberately accepted the possibility" that funds might return from abroad and that waxing foreign exchange surpluses might "again cause . . . headaches".

#### QUESTIONS FOR THE FUTURE

Germany's external surpluses, which have already attracted so much attention, seem likely to remain in the forefront of discussion in the near future. German official gold and net foreign exchange holdings<sup>4</sup> rose from \$1.1 billion equivalent at the end of 1952 to \$6.2 billion at the end of 1958 (see Chart III), the largest holdings of any single Free World country after the United States. Although in the first nine months of 1959 these holdings

<sup>4</sup> Including balances held under payments agreements, net claims on the European Payments Union through 1958, and in 1959 net claims under the European Monetary Agreement.



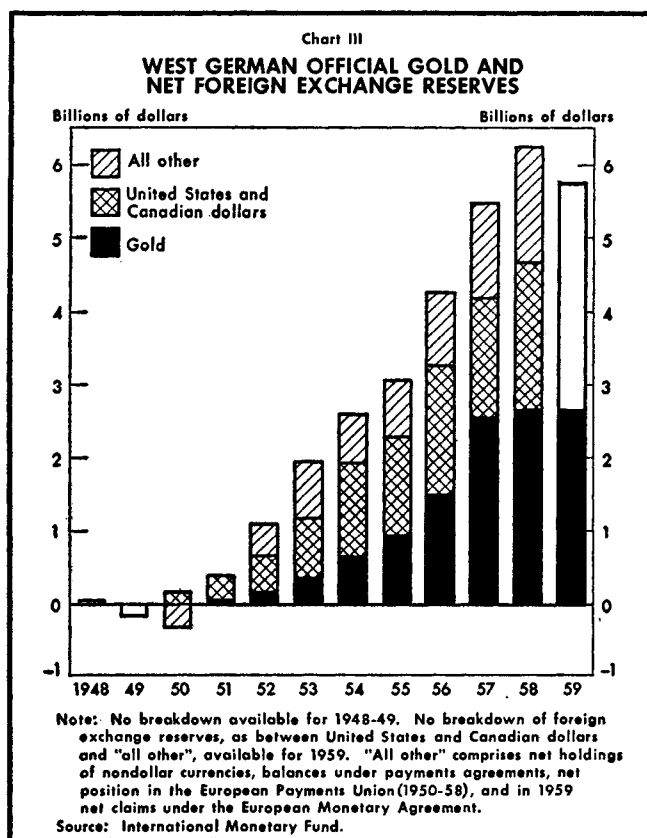
declined to \$5.2 billion—partly as a result of repayments on foreign indebtedness, and partly because of rising interest rates in the United States and Canada that stimulated an outflow of capital from Germany—they were back to \$5.7 billion by the end of the year. The accumulation of these sizable holdings, and the possibility of continued gains, are obviously of paramount concern to Germany's trading partners, some of whom have questioned whether German domestic economic conditions actually warranted actions that were bound to lead to a further accumulation of reserves.

Domestic considerations, however, may well become even more important, since a number of major structural changes appear to be taking place in the German economy. These changes may, before long, make it more difficult to preserve price stability, although they may tend to reduce

the magnitude of the external problem. In the public sector, a new phase of budgetary deficits may be in the making inasmuch as ordinary and defense expenditures are rising and disbursements for social services and benefits are being increased. At the same time, labor's bargaining position has grown stronger with the reduction in unemployment to low levels and the slower rise in the labor force. This circumstance may portend wage demands in excess of productivity advances, creating the problems for price stability that many other countries have faced.

Other changes that are currently taking place appear to foreshadow a slowing-down in the rapid growth rate of the past ten years. The quickened pace of private consumption in 1959, if it continues, may well reduce the savings ratio. The uptrend in consumption has been reflected in and partially supported by the current spectacular rise in consumer credit, and has fostered recent price increases. At the same time, the period of quick returns from investment outlays may be drawing to a close. The most obvious gaps in plant and equipment have been filled, labor has become scarce rather than ample, and investment is therefore tending to be directed toward labor-saving and capital-intensive projects. Lower returns on capital may also ensue as a greater share of the total is devoted to the economy's overhead facilities—including roads and communications—which have not in all cases kept up with the expansion of production.

Under these conditions, the monetary authorities may find themselves confronted with a delicate dilemma. On the one hand, they will of course wish both to offset any additional liquidity generated by the public sector and to contain price and wage pressures in general. On the other hand, the authorities will wish to pursue their goal of gradually lowering the over-all interest rate level, in order both to help reduce the external surpluses through short- and long-term capital exports and to encourage an adequate level of domestic investment as profit margins are squeezed by rising wages. The maintenance of monetary stability thus will require much wisdom and financial statesmanship in order that the gains achieved so far may be preserved and continued. The success that Germany's postwar economic policies have had in reconciling growth with relative price stability is reassuring evidence that any future problems will be solved.



## Federal Reserve Publications

The following Federal Reserve System publications are available from the Publications Division of the Federal Reserve Bank of New York, New York 45, N. Y. Where a charge is indicated, remittance should include sales tax, if applicable.

**The Federal Reserve System, Purposes and Functions.** A 208-page booklet, explaining the structure, objectives, and methods of operation of the Federal Reserve System.

**Money: Master or Servant?** A 48-page booklet explaining in nontechnical language the role of money and banking in our economy.

**Federal Reserve Operations in the Money and Government Securities Markets.** A 105-page booklet discussing the manner in which operations are conducted through the Federal Reserve Bank of New York's Trading Desk in carrying out the directions of the Federal Open Market Committee.

**The Money Side of "The Street".** A 103-page account of the workings of the New York money market including a discussion of the functions and usefulness of the short-term wholesale money market and of its role in the operations of the Federal Reserve. 70 cents per copy; 35 cents a copy on orders from educational institutions.

**The Quest for Stability.** A 54-page booklet of five essays describing efforts to achieve an efficient monetary system in the United States.

**Forty-five Years of the Federal Reserve Act.** An 18-page booklet describing in layman's language the history of the Federal Reserve Act from 1913 to 1958.

**Readings on Money.** A 47-page booklet, discussing the nature of money and the processes of its creation and circulation. Articles include the rising money supply, currency and coin, kinds of currency and coin, demand deposits, bank reserves, and money lenders.

**Deposit Velocity and Its Significance.** An 88-page booklet on the behavior of deposit velocity, over the business cycle and over long periods. 60 cents per copy; 30 cents per copy on orders from educational institutions.

**Workbook on Bank Deposits, Bank Reserves, and Currency.** A 19-page booklet of exercises in "T account" form, explaining some of the major transactions that affect member bank deposits and reserves, such as deposit creation and destruction, gold flows, Treasury receipts and expenditures, and the effects of Federal Reserve actions.

**Exercises in the Debits and Credits of Bank Reserves.** A 16-page booklet of exercises, in simple "T account"

form, indicating the essential nature of transactions affecting bank reserves. Explanations include the effect on reserves of changes in Federal Reserve credit, gold and currency flows, and Treasury transactions.

**The New York Foreign Exchange Market.** A 56-page booklet describing the New York foreign exchange market as it exists today. 50 cents per copy; 25 cents a copy on orders from educational institutions.

**Foreign Central Banking: The Instruments of Monetary Policy.** A 116-page booklet describing the development of central banking techniques abroad during the postwar period.

**Monetary Policy Under the International Gold Standard, 1880-1914.** A 62-page analysis of the performance and policies of central banks under the pre-1914 gold standard, in the light of current monetary and banking theory. 50 cents per copy; 25 cents per copy on orders from educational institutions.

Each of the Reserve Banks publishes a monthly review of credit and business developments available upon request from the following addresses. The Board of Governors of the Federal Reserve System (Washington 25, D. C.) publishes the *Federal Reserve Bulletin* monthly; an annual subscription in the United States costs \$6.00.

Federal Reserve Bank of Atlanta  
Atlanta 3, Georgia

Federal Reserve Bank of Boston  
Boston 6, Massachusetts

Federal Reserve Bank of Chicago  
Chicago 90, Illinois

Federal Reserve Bank of Cleveland  
Cleveland 1, Ohio

Federal Reserve Bank of Dallas  
Dallas 13, Texas

Federal Reserve Bank of Kansas City  
Kansas City 6, Missouri

Federal Reserve Bank of Minneapolis  
Minneapolis 2, Minnesota

Federal Reserve Bank of New York  
New York 45, New York

Federal Reserve Bank of Philadelphia  
Philadelphia 1, Pennsylvania

Federal Reserve Bank of Richmond  
Richmond 13, Virginia

Federal Reserve Bank of St. Louis  
St. Louis 2, Missouri

Federal Reserve Bank of San Francisco  
San Francisco 20, California