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Board of Governors of the Federal Reserve System
Division of Research and Statistics
International Sections

REVIEW OF FOREIGN DEVELOPMENTS

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CURRENCY REFORM IN AUSTRIA

J. Herbert Furth

The Austrian Government's bill putting into effect its long-discussed plans for currency reform was passed by Parliament against the votes of the insignificant Communist minority, and at present is being acted upon by the Allied Council. If the Council unanimously approves the law, it will immediately go into effect. If it is approved by majority vote, the effective date will be delayed by one month. In that case it is possible that the Government will decide to withdraw the bill, in order to avoid the extreme hazard of such a long period of transition and also in order not to incur more disfavor with the Soviet Union, the only occupation power likely to oppose approval of the bill.

The bill provides for the exchange of all schilling bank notes at the rate of 3 to 1, with a proviso that 150 schillings ($15) per head will be exchanged in full and that farmers also will receive full value for the amount of their legal deliveries of farm produce since June 1947. Further clauses aim at protecting the value of wages and salaries and other income in hardship cases, received during the period of transition. Bank deposits made after November 12, 1947 (the day on which knowledge of Cabinet discussion of the impending currency reform first became known to the public) will be treated like currency.

In general, other deposits in Austrian banks will be treated more favorably than cash. Of those deposits that were made before liberation and therefore blocked under the first currency reform law of December 1945, 60 per cent will be wiped out (with exceptions in hardship cases) and 40 per cent exchanged for 2 per cent government bonds. Of all other private deposits, 1,000 schillings and 50 per cent of the rest will remain free, and 50 per cent will be blocked, 25 per cent for six months and 25 per cent for nine months. Of all government deposits, 50 per cent will remain free, 25 per cent will be blocked for one year, and 25 per cent will be wiped out. Deposits of the occupation powers with Austrian banks will be treated like private deposits. If this report is correct, the substantial holdings of the Soviet Union and the sovietized Austrian enterprises all would be treated like cash and accordingly reduced by two-thirds since the bulk of these holdings is not deposited with Austrian banks. This is the reason why strong opposition from the Soviet Union is to be expected.

On November 15, 1947 the Austrian National Bank showed a note circulation of 6 billion schillings. Under the proposed law, this circulation would be reduced to about 2.7 billion schillings, assuming no preferred treatment of allied holdings. In addition, the law would free the National Bank of one-fourth of its government deposits and of blocked deposits of 3.4 billion schillings, and all other banks of the bulk of their blocked deposits of approximately 8.1 billion. At the same time, the Government would be burdened with a debt of 4.5 billion schillings requiring annual interest payments of 90 million schillings.

Altogether the reduction of means of payment in circulation (including all deposits) may be estimated as follows:

ESTIMATED EFFECT OF CURRENCY REFORM
(Billions of schillings)

		Amount Before Reform	Amount After Reform	Amount December 31, 1937
Note circulation		6.0	2.7 1/	0.9
Deposits: National Bank -	Free	3.0	1.5	0.2
	Blocked	3.4	1.2	-
Other demand deposits	Free	4.8	2.5	1.0
	Blocked	1.9	2.5	-
Savings deposits	Free	3.0	1.6	3.0
	Blocked	6.2	2.0	-
Total		28.3	14.0	5.1

The estimated post-reform circulation of 2.7 billion schillings in bank notes, 2.7 billion in National Bank deposits, 5.0 billion in other demand
3.6 deposits, and ~~2.7~~ billion in savings deposits, making a total of 14.0 schillings, will be about half of the present amount of free and blocked means of payments, but almost three times as high as ten years ago. This increase corresponds approximately to the rise in the price and wage level, and also to the

1/ Including Soviet holdings under the assumption that these will not receive preferential treatment.

change in the foreign exchange value of the schilling, adjusted for the changes in dollar prices on the world market.1/ If Austria's economic activity were up to prewar levels, it might be expected that the currency reform might go a long way toward eliminating the discrepancy between effective demand and supply, which creates the threat of inflationary spirals. Unfortunately, Austria's level of production probably is not much higher than one-half of 1937, and therefore part of the inflationary gap will continue as long as there is no decisive change in production. The inflationary pressure will be substantially reduced, however, and it is to be hoped that the stimulus to be given to the Austrian economy through interim aid and the planned European Recovery Program gradually will close the gap.

The currency reform will not affect U.S. holdings of Austrian currency to any appreciable amount. Under the new "pay-as-you-go" agreement, all expenditures of the U.S. forces in Austria are being paid for in dollars, and all U.S. holdings of schillings paid for in dollars are guaranteed by the Austrian Government against losses by devaluation, including losses incurred in consequence of currency reform. No other occupation power has purchased appreciable amounts of Austrian currency with foreign exchange, and therefore the other powers cannot claim the same protection for their holdings. Nevertheless, the preferred position of U.S. holdings is likely to be an additional incentive for protest by the Soviet Union against any reduction in the value of its schilling hoards.

The opposition of the Communists to the reform is ostensibly based upon the contention that small savers, holding pre-liberation deposits and cash, are treated more severely than the wealthier classes who hold most of their liquid funds in current deposits. In order to counteract this opposition, the Government has promised a comprehensive capital levy which will compel the wealthier classes to make sacrifices as great as those imposed upon small savers. Currency reform inevitably is accompanied by some hardship and injustice. A more fundamental reason for Communist opposition presumably is the proposed reduction in the holdings of the Soviet Union and its Austrian enterprises.

If the Soviet Union is determined not to permit such a reduction, and if the Austrian Government in turn is not willing either to abandon the reform altogether or to exempt Soviet enterprises from its application, the conflict may have serious consequences. The Soviet Union might prevent the reform from being executed in its zone of occupation and thereby in fact split the Austrian economy in two parts. On the other hand, an exemption of the Soviet Union from the reform would increase its possession of Austrian currency from an estimated one-sixth to more than one-fourth of the total. The mechanism of Austrian legislation, requiring the submission of all statutes to the Allied Council, already has impaired some of the favorable effects of the reform. During the period of transition, the velocity of circulation of money has increased and prices have risen substantially. According to the latest reports, the Government has fined the worst offenders against price ceiling regulations and has put an end to the spending spree that followed the announcement of the reform.2/

1/ See this Review, October 7, 1947, p. 1
2/ In order to counteract hoarding of postage stamps, the Government has announced that existing stamps will become invalid when the reform goes into effect.

Any extension of the period of uncertainty, however, is bound to endanger financial stability. The reform can be successful only if the Austrian Government, perhaps by means of a workable compromise with the Soviet Union, can put the bill into full effect without further delay.

FRENCH FOREIGN TRADE: CUSTOMS VS. EXCHANGE CONTROL STATISTICS

A. O. Hirschman and
Carolyn Lichtenberg

The French Ministry of Finance has recently published a breakdown of the over-all balance of payments for 1946 by monetary areas and principal countries.[1] These bilateral balances of payments show in detail exports and imports separately for France and for French dependencies. In its first part, the present article will compare these new data on French foreign trade and its geographical breakdown with the customs statistics. The second part will attempt to readjust French import statistics in the light of the new information yielded by the balance of payments figures.

I. Comparison of Customs and Balance-of-Payments Statistics on Geographical Breakdown of French Foreign Trade in 1946

The customs statistics in 1946 were, and still are, notoriously deficient with respect to imports, primarily as a result of valuation of imported products at domestic subsidized prices, but also because of the general laxity of customs authorities with regard to Governmental imports which played a considerable part in the total. Furthermore, it is suspected that a portion of 1946 imports which had been ordered in 1945 was mistakenly converted in the customs statistics at the exchange rate of 50 rather than 119 to the dollar. These deficiencies resulted in a considerable undervaluation of French imports by the customs statistics which quoted total French imports on a c.i.f. basis from foreign countries at 181 billion francs against the balance-of-payments figure of 236 billion francs for imports net of costs for freight, insurance, etc. The foreign exchange outlay for such costs amounted to another 32 billion francs.

Obviously, even if the customs statistics did not suffer from the shortcomings noted above one still would expect substantial differences between customs and balance-of-payments data relating to merchandise trade. While the customs data relate to the physical flow of goods, the balance-of-payments data are based on the records of the French Exchange Control Office (Office des Changes) and relate to actual payments and receipts. Differences between the two sets of data must therefore be expected, e.g. because of the lag of payment behind shipment and down payments on orders for equipment. As will be seen, differences due to these factors may, however, shed some new light on the conditions of international trade and payments.

Table I compares the balance-of-payments data with the customs data on imports and exports. The major difficulty in preparing this table consisted in forcing the customs data into the pattern given by the available country breakdown of the balance of payments which, aside from specific countries, con-

1/ Ministere des Finances: "Balance des Payements de l'année 1946 entre la zone franc et les pays étrangers," Paris 1947, 37 pages.

tains the broad categories "dollar area" and "sterling area". A somewhat arbitrary decision had to be made as to the countries presumably belonging to each of these areas.[1] With respect to isolated dollar purchases in certain countries not normally belonging to the dollar area, allowance was made for the fact that wheat imported from Russia in 1946 (544,000 metric tons) was paid for in dollars at a price believed to be in the vicinity of the c.i.f. price then prevailing for U. S. wheat.

A further difficulty consisted in the fact that customs data on imports are on a c.i.f. basis whereas the balance-of-payments figures show for each country the f.o.b. value of imports and, as a separate item, the foreign exchange outlay for freight, insurance, and other costs incident in merchandise trade. These figures are therefore exclusive of that part of freight costs which was paid in francs to French shipping companies moving imports into France. However, rather than to have recourse to arbitrary mark-ups in order to convert the balance-of-payments figures to a c.i.f. basis, it has been decided to add to the import data the actual balance-of-payments figures on outlay for freight and other costs; it is believed, indeed, that the resulting understatement of the c.i.f. value of imports would not be serious since the French merchant fleet was badly depleted in 1946 and was largely engaged in carrying on trade with French overseas dependencies.

1/ The customs figure for the dollar area has been arrived at by adding the customs data for the following countries:

United States	Venezuela
Chile	"Other America"
Cuba	China
Mexico	Japan
Peru	Germany

plus 2,473 million francs for wheat from Russia (customs figure). The countries where transactions were presumed to take place in sterling are:

United Kingdom	India
Iraq	Arabia
Egypt	Iran
South Africa	Siam
New Zealand	"Other Asia"
Australia	"Other Africa"

Syria-Lebanon is part of the franc area for purposes of the exchange control statistics.
All customs figures were taken from the Statistique Mensuelle du Commerce Exterieur de La France. Année 1946, p. 468-469

Table I
French Foreign Trade in 1946 According To Balance of Payments and Customs Statistics
(In billions of francs)

Country	IMPORTS Customs	Balance of payments	Ratio (1): (2)x 100	EXPORTS Customs	Balance of payments	Ratio (4): (5) x 100
	(1)	(2)	(3)	(4)	(5)	(6)
Total	180.7	267.6	67.5	67.0	53.9	124.1
Dollar Area	89.2	149.2	59.8	10.7	9.4	113.1
Canada	7.9	14.8	53.2	.5	.2	280.3
Sterling Area	37.0	50.8	72.8	10.1	11.7	86.8
Argentina	11.2	11.4	97.6	1.2	.8	140.8
Belgium-Luxembourg	10.3	11.8	87.1	20.6	13.6	152.1
Brazil	1.6	2.0	80.9	.8	.6	144.6
Denmark	1.0	2.3	45.2	1.1	.8	133.2
Netherlands	1.9	2.6	74.0	3.5	2.8	128.5
Italy	2.3	1.0	224.6	.6	.6	111.1
Norway	2.0	3.3	59.2	1.4	.8	178.9
Portugal	.8	1.5	51.1	1.0	1.2	81.3
Sweden	4.4	5.4	82.9	3.3	2.9	114.8
Switzerland	7.1	9.0	78.9	9.6	7.5	127.2
Czechoslovakia	.7	1.1	64.9	.6	.5	116.1
Turkey	.6	.1	456.7	.1	.003	3600.0
Other Countries	2.7	1.3	216.8	1.7	.6	299.7

Imports. The table reveals mainly that the discrepancy between exchange control data and customs statistics is particularly great with regard to imports from the dollar area. This is in accordance with expectations because of the dollar area's large coal and wheat shipments appearing in customs statistics at subsidized internal prices. The balance-of-payments figures, however, may be inflated with respect to the actual merchandise flow because of down payments on equipment orders.1/ This factor may also be responsible for part of the particularly large discrepancy between the two figures in the case of Canada (railroad and other equipment) and Denmark (ships). In the case of Norway, the discrepancy is largely due to the fact that in the balance-of-payments figures payments to Norwegian ships, amounting to almost half of Norwegian exports, are far in excess of the actual freight outlay for imports from Norway and represent freight due to Norwegian ships for carrying French imports from other countries.

The balance-of-payments figures are smaller than the customs figures in the cases of Italy, Turkey, and "Other countries". A tentative explanation for Italy will be given below. For Turkey, it appears that the French Treasury secures payment for interest and amortization on Turkish loans in the form of tobacco, this operation not being recorded on either side of the balance of payments. Finally, with respect to other countries, the discrepancy is

1/ Advance payments for equipment orders placed by the French Government in the United States are estimated at $30 million or 2.5 billion francs for 1946.

due mainly to various errors and omissions which must have occurred in defining the dollar and sterling areas for the purpose of fitting the customs figures into these categories.

Exports. Since payments normally lag behind shipments one is led to expect a smaller figure for payments than for shipments in a period of expanding trade such as the year 1946. However, the total discrepancy of 14 billion francs between the balance of payments and the customs figures is by no means equally distributed. Belgium alone accounts for one-half of the discrepancy, and Switzerland for another 2 billion.1/ These large differences are due to a variety of factors: In the first place, French customs statistics traditionally overstate French exports to Belgium because merchandise merely transiting through Belgium and destined for overseas (via Antwerp) is entered as an export to Belgium. Secondly, there has probably taken place during 1946, in Belgium as in Switzerland, an accumulation of French goods (wines, etc.) on consignment for which payment is made only when the goods are sold to the final consumer. But to a significant extent, the discrepancy in the case of both countries, and particularly in Belgium, reflects a capital flight that has taken the form of a delay in repatriating export proceeds through collusion between French exporters and Belgian (or Swiss) importers. This collusion consists in the French exporter's pretending, with the support of documents from his Belgian customer, that he is unable to collect his outstanding credits in Belgium. An investigation of the French Exchange Control Office during July 1947 yielded the information that credits of from two to three billion Belgian francs, i.e., from 5 to 7 billion French francs, were outstanding in this fashion. After French representations, the Belgian National Bank made settlement of commercial accounts on the part of Belgian importers compulsory within the period of 30 days of the receipt of the merchandise.

A similar phenomenon of capital flight, but in the opposite direction, is most likely the explanation for the fact that the customs figure for French imports from Italy is more than twice as large as the corresponding balance-of-payments figure. In this case, Italian exporters probably have induced French importers to delay payment through the clearing in view of the expectation that the clearing rate for the lira would be lowered in accordance with other exchange rate developments in Italy during 1946.

While one of the major interests of the comparison between customs and exchange control statistics lies in the observation of exchange control violations and evasions, it should be noted that the most obvious form of capital flight via merchandise transactions, i.e., undervaluation of exports and over-valuation of imports, escapes detection by this method since it would affect both exchange control and customs statistics.

For the sterling area, the balance-of-payments figures for exports are higher than the customs figures. This may be explained by French exports via Belgium to the sterling area which, as explained above, are shown by customs statistics as exports to Belgium.

1/ Percentagewise, the highest discrepancy is noted for Turkey. No information is available to account for it.

II. Adjustment of French Import Statistics for 1946

With respect to imports, the deficiencies of the customs statistics and the discrepancies between the two sets of import figures presented above are sufficiently serious to warrant an attempt at reconstructing the French import statistics in the light of the new information available.

Table II presents this attempt. In general, the balance-of-payments data have been given preference over the customs figures except where indicated in the footnotes. The breakdown of the dollar area, the sterling area, and the "other countries" into individual countries and groups of countries was carried out by applying the known breakdown of the customs figures for these areas to the balance-of-payments figure.

The adjusted data presented in Table II still differ appreciably from a record of French imports that would be ideally correct from the point of view of traditional methods of customs valuation. But it is believed that the adjusted data are a better approximation of the actual flow of French imports during 1946 than the figures hitherto available.

Table II
French Imports in 1946, Customs Data and Adjusted
Estimates Based on Balance of Payments Data

COUNTRY	CUSTOMS Billions of Francs	CUSTOMS Percent of Total	ADJUSTED Billions of Francs	ADJUSTED Percent of Total
Total	180.7	100.0	263.8	100.0
United States	65.3	36.1	106.0 d/	39.2
Canada	7.9	4.4	14.8	5.6
Latin America	(22.5)	(12.5)	(29.4)	11.1
Argentina	11.2	6.2	11.4	4.3
Brazil	1.6	.9	2.0	.8
Chile	2.1	1.2	3.5	1.3
Cuba	.8	.4	1.3	.5
Mexico	.5	.3	.8	.3
Peru	.6	.3	1.0	.4
Venezuela	3.1	1.7	5.2	2.0
Rest of Latin America	2.6	1.4	4.2	1.6
Europe	(61.4)	(34.0)	(83.0)	(31.5)
Belgium-Luxembourg	10.3	5.7	11.8	4.5
Czechoslovakia	.7	.4	1.1	.4
Denmark	1.0	.6	2.3	.9
Germany	11.1	6.1	18.4	6.9
Italy	2.3	1.3	2.3 a/	.9
Netherlands	2.0	1.1	2.6	1.0
Norway	2.0	1.1	2.5 b/	.9
Portugal	.8	.4	1.5	.6
Russia	2.8	1.5	5.3	2.0
Spain	.2	.1	.1	*
Sweden	4.5	2.5	5.4	2.0
Switzerland	7.1	3.9	9.0	3.4
Turkey	.6	.3	.6 c/	.3
United Kingdom	13.9	7.7	19.1	7.2
Other Eastern Europe	1.7	.9	.8	.3
Other ERP Europe	.4	.2	.2	.1
Asia	(6.7)	(3.7)	(9.5)	(3.6)
Arabia	.6	.3	.8	.3
China	.4	.2	.6	.2
India	1.9	1.1	2.7	1.0
Iran	1.0	.6	1.4	.5
Iraq	1.7	.9	2.3	.9
Japan	.2	.1	.4	.2
Rest of Asia	.9	.5	1.3	.5
Africa	(6.9)	(3.8)	(9.5)	(3.6)
Egypt	2.2	1.2	3.0	1.1
Union of South Africa	2.5	1.4	3.5	1.3
Rest of Africa	2.2	1.2	3.0	1.1
Australia	8.7	4.8	12.0	4.5
New Zealand	1.3	.7	1.8	.7
Unallocated Freight Charges a/	-	-	.8	.3

a/ As explained in text (p.7) customs figure chosen as more reliable.
b/ Balance of payments figure but freight added only to extent of 10 per cent of imports. Remaining freight payments to Norway appear at end of table as unallocated freight charges.
c/ As explained in text (p. 6) customs figure used.
d/ Computed figure reduced by 2.5 billion francs (see footnote 1/ on p. 6)
* Less than .1 percent

GENEVA DRAFT OF THE I.T.O. CHARTER: EXCHANGE CONTROLS AND QUANTITATIVE RESTRICTIONS

Florence Jaffy and
Frank M. Tamagna

The new draft charter of the International Trade Organization, prepared at Geneva this summer, and which will be presented to the Havana Conference which opened on November 21, does not basically change the substance of the provisions on quantitative trade restrictions, exchange controls, and relations with the International Monetary Fund. Certain changes in form and emphasis appear, chiefly in regard to consultation with the Fund, and in regard to the rule of non-discrimination.

Consultation with the International Monetary Fund

The earlier New York draft of the I.T.O. charter provided, in the paragraphs dealing with specific cases of quantitative restrictions, that the International Monetary Fund was to be consulted, or was to join in discussions between the member and the I.T.O., in various specified circumstances. The present version removes all reference to consultation with the Fund to a separate Article, wherein it is provided that the Fund shall be consulted in regard to all "problems concerning monetary reserves, balance of payments or foreign exchange arrangements". The Article further provides that in regard to these matters, the I.T.O. shall "accept all findings of statistical and other facts" presented by the Fund, including the Fund's judgment as to the state of a member's monetary reserves, and also determination by the Fund as to whether a member's action is in accordance with the Fund Agreement.

The effect of this change is to make more flexible the requirement for consultation with the Fund: while consultation is rendered less certain in any given case, it is made possible in borderline cases which might not have come under specific provisions. At the same time, the matters on which the Fund's decision is to be accepted as final are specified more clearly.

The importance which consultation will assume, in the absence of any power given the Fund in its Articles of Agreement, will depend on the final formulation of the I.T.O. Charter, and on the I.T.O. attitude toward the Fund. The latter in turn will depend in part on the representative and voting strength given various countries in the I.T.O., a matter which has not yet been settled. However, the I.T.O. is required by the Draft Charter to seek a formal agreement with the Fund, and such an agreement will doubtless further define the scope of consultation. It should be noted that the I.T.O. is bound by its charter as at present formulated, to certain action dependent upon previous Fund decisions, while the Articles of Agreement do not contain any corresponding obligations on the part of the Fund. If meaningful cooperation between the two agencies is to become a fact, it will be necessary for the proposed agreement to set forth the powers and responsibilities of the Fund as well as the I.T.O.

Exceptions to the Rule of Non-discrimination

While both the New York and the Geneva drafts emphasize the principle of non-discrimination as between countries in the administration of quantitative restrictions, there has been some rewriting of the section dealing with permitted departures from this rule. The earlier draft listed a number of cases where discrimination was allowable - for example, as among countries having a common quota in the Fund; or to assist war-disrupted economies until

December 1951; or to ensure that an exporting country is paid for its exports in its own currency or in that of a specified third country; and in several other cases. The new version places special emphasis on the recognition that in conditions of "substantial and widespread disequilibrium" discrimination may make it possible for a country to increase its imports without "unduly depleting its monetary reserves". Consequently, when such a disequilibrium prevails, members are permitted to give special discriminatory preferences in order to obtain more imports than they could otherwise afford. (A somewhat similar provision appeared in the New York draft, but with far less emphasis and detail). This discrimination is permitted, however, only under certain specified conditions: The prices paid to the preferred country should not be "substantially higher" than those obtainable elsewhere and should be progressively reduced; the preference is not to be part of an arrangement whereby the member's current earnings of convertible currency from other members are appreciably reduced; and the action is not to "cause unnecessary damage to the commercial or economic interests of any other member".

Miscellaneous Changes

The new draft contains expanded emphasis on consultation with, and review by the I.T.O. It removes reference to "commercial considerations" as a basis for non-discriminatory allocation of import quotas. It adds the stipulation that members, in removing maladjustments in their balance of payments which may be causing difficulties to other members, shall pay due regard to the desirability of using methods that expand, rather than contract international trade.

The I.T.O., in the Geneva Charter, undertakes the new obligation of reporting to the Fund any cases of exchange control which it believes inconsistent with its own regulations regarding quantitative restrictions.

Finally,[1] by a new footnote, the Geneva draft alters, or at least expands the meaning of the clause which requires that "members shall not seek by exchange action to frustrate the intent" of the Charter, and "shall not seek by trade action to frustrate the purposes of the International Monetary Fund". As the word "frustrate" is now interpreted, by means of a footnote, it is made clear that, if a member violates the letter of any article of the Charter, but does not depart appreciably from its intent, that member is not to be considered an offender.

Conclusion

The Geneva session has not made any great changes in the Draft Charter of the I.T.O. in regard to quantitative restrictions and exchange control, and has not altered the general position vis-a-vis these problems. The new version of the Draft Charter seems to guarantee further the right of members to take protective measures in cases of need, but appropriately to hedge such guarantees with specific conditions and general cautions and to subject them to the requirement of I.T.O. approval. The new provisions for cooperation with the Fund are difficult to appraise. If the I.T.O. desires to consult the Fund on a variety of matters, the new arrangement seems

1/ There are further small changes not mentioned here. The general tenor of which is covered in the concluding section of this note.

to offer a broader legal basis than the old. If the I.T.O. does not wish to do so, the new provisions may offer loopholes. It would seem rather difficult, however, to show any case in which quantitative restrictions and discrimination do not involve "monetary reserves, balance of payments or foreign exchange arrangements". The new Draft Charter, in effect, defers the definition of the relations between the I.T.O. and the Fund to the prospective agreement between the two organizations.

THE ACCELERATING CHINESE INFLATION

Arthur B. Hersey

On Tuesday, November 25, the black market value of a U.S. dollar note in Shanghai was about $130,000 in Chinese national currency and the price for telegraphic transfers was one or two per cent higher.1/ (In 1937 CN$3.35 would buy one American dollar.) The black market is used for inward remittances or transfers of undeclared export proceeds and for outward flight of capital or purchase of illegal imports but the rates have a considerable influence upon commodity markets. The market is linked by clandestine radios to that of HongKong, where no real attempt has been made to suppress dealings in U.S. currency. The November 25 rates were three times the rates ruling during an earlier period of comparative stability from July to mid-September, and about 60 per cent above the October average. Military setbacks, an influx of flight capital from North China, and disappointment over the scale of aid which the Chinese Government can apparently count on from the United States all have been given as reasons for the violence of the September-November depreciation.

The latest attempt to stimulate exports and encourage inward remittances through official channels—by a moveable "official open market" exchange rate applied to all transactions but imports of a few essentials2/—is apparently proving less successful than had been hoped. The Central Bank's Exchange Equalization Fund Committee (operating in consultation with Chinese and foreign commercial banks) rightly fears that every advance in the official open market rate will stimulate more depreciation in the illegal exchange market as well as in commodity markets. On the other hand, the emergence of a wide gap between the official rate and the black market rate diverts virtually all remittances away from official channels and reduces the profitability of exporting any goods the domestic prices of which are sympathetically af-

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1/ There have been fluctuations above and below this level since November 25. The appointment of President Chiang's son to supervise enforcement of anti-inflation measures in Shanghai, announced on December 1, was followed by an appreciation of the black market rate from CN$140,000 to CN$125,000 according to press reports.

2/ Imports of cotton, wheat, rice, coal and fertilizer can still be paid for at the fixed official rate of $12,000 to $1 established in February 1947. Previously this rate had been fixed at $3,350 (from August 1946) and $2,020 (from March 1946).

fected by the illegal exchange rate.1/ The official open market rate was gradually raised from CN$38,500 (late August and early September) to CN$73,000 on November 25. This left a gap of 80 per cent to the black market rate of CN$130,000, a gap about as wide as had ever existed between the old fixed official rates and black market rates before May-August 1947.

Chinese net short-term assets in the United States, were under U.S. $170 million at the end of September,2/ and are continuously declining although imports are being licensed more and more restrictively. China's exports in 1946 and 1947 have been only about one-third the prewar volume.

Underlying all these developments is the continuous inflation of the Chinese currency. This in turn is a function of (1) military requirements, (2) the grave shortage of revenue, and (3) intermittent sharp price rises. The cycle of monetary and price inflation gains momentum as it proceeds. Under present conditions, however, it is impossible for the Government to avoid continuous borrowing from the Central Bank. A major part of the Government's tax revenue is derived from excise taxes and customs duties. Although total revenues are substantially larger, in real terms, than during the war, expenditures are also larger and tax receipts still cover only a small part of total requirements. The effectiveness of taxation is limited by inefficiency in administration (to some extent unavoidable) and by lags in collection which tend to reduce the real value of taxes as prices rise. On the expenditure side, there have been widespread reports of graft and inefficient administrative controls.3/ Although a part of the Government's expenditures can be covered by direct use or net sales of its foreign exchange resources (and in 1946 funds were realized from sales of gold in the domestic market), a major part of total expenditures has to be met by the printing of new money. With large amounts of new money continually being used to bid away goods and services for the military, price advances are inevitable. The economy has become thoroughly habituated to prices rising, (irregularly, perhaps, but with a continuous trend.4/

Two features of the inflation in 1947 are especially interesting and significant. These are shown by the figures in the table. One is an acceleration 5/ of the general upward trend (columns 2 to 4). The other is a greater rise in black market currency rates and the price of gold than in

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1/ The linkage of export prices with the black market dollar rate is not evident in the official Shanghai price index for tung oil, hides, and bristles, but has been mentioned frequently in market reports from Shanghai. The official price index for metals—covering copper and iron, neither of which are exported—has in fact shown the closest parallelism of all groups with the black market exchange rate.

2/ Official and private short-term assets (the latter chiefly banking funds), less short-term liabilities. No figures have been published on holdings of gold, sterling exchange, or silver. Much of the gold acquired with U.S. wartime financial aid has been sold.

3/ For example, disbursing officers obtaining funds in advance of actual requirements may make a quick profit in the interim by speculation on their own account.

4/ It is significant that black market interest rates are of the order of 10-15 per cent per <u>month</u> in periods of comparative "stability" and 20 per cent per month in periods of rapidly advancing prices.

5/ "Acceleration" is measured in terms of <u>ratios</u> of depreciation. For example, an index which rose from 100 to 200 in one period would be said to show an accelerated rise only if it went beyond 400 in the next period.

commodity prices.[1] Both of these developments are new symptoms of a growing lack of confidence in the National Government's power to deal with its politico-military and economic problems.

	Index as of Oct. '47 (1st½ '37 = ONE)	Number of Times by Which Index Increased Apr '46 to Oct '46 (1/2 year)		Oct '46 to Apr '47 (1/2 year)		Apr '47 to Oct '47 (1/2 year)		Apr '46 to Oct '47 (1½ years)
Official US$ rate[a]	16,400	1.7	x	3.6	x	4.5	=	27
Black Market US$ rate	24,000	2.0		3.5		5.3		37
" " gold price	37,000	1.4		3.2		6.1		28
Wholesale price indexes								
Chungking	28,000	1.2		2.4		5.7		16
Shanghai:								
Foods	57,000	2.1		2.5		4.1		22
Agr. Export Prod.[b]	33,000	1.7		3.4		3.9		22
Metals	95,000	2.0		4.9		4.9		48
Fuels	156,000	1.3		3.0		5.2		20
General index[c]	60,500	2.1		2.7		4.2		23
Canton	46,000	n.a.		n.a.		3.7		n.a.

Note: Wholesale price indexes used are monthly averages except Oct. 1947 for which daily indexes of Oct. 11 are used. Black market dollar and gold rates are monthly averages of Thursday or Friday rates.

a/ From Aug. 18, 1947, "official open market" rate.

b/ Three commodities only: tung oil, hides, bristles.

c/ Includes also building materials (rise similar to food) and textiles (present level like foods as compared with prewar, but pattern of recent increases resembles that for fuels).

This acceleration of the Chinese inflation will force the Government to put money into circulation in larger denominations than it has hitherto used. After long hesitation CN$5,000 and CN$10,000 notes[2] were first introduced in January 1947. Fears that such official recognition of the extent to which the inflation had already gone would bring on new and more rapid price rises were confirmed by the violent movement in the first half of February. Since commodity prices in October were 10 times as high as at the beginning of 1947, and are now much higher, the emission of CN$50,000 and CN$100,000 notes is overdue. Rumors that CN$50,000 notes would soon be introduced have been heard in recent weeks.

Excessive delay in shifting to larger denominations, either for lack of preparation or as a matter of financial policy, will create serious problems in the transportation of money. Delay in supplying an adequate quantity of notes to military disbursing officers may have direct military consequences, and it may react also on the economic situation in port cities. In

1/ Figures for the note issue are not published but it is generally believed that the rate of increase has been comparable with the trend of rise in commodity prices.

2/ These were actually denominated as 250 and 500 Customs Gold Units, respectively. The Customs Gold Unit is an obsolete accounting unit, now taken as equivalent to CN$20.

November there were reports that a stringency of cash at inland collection points was hampering the trading and transportation of food and export commodities which would otherwise be moving to Shanghai and other port cities. If, in order to avoid such problems as these the Government should ever find it necessary to hastily print inferior currency (poor plates, lack of serial numbers, etc.) or to overprint lower denomination stocks on hand, the unfavorable effects of putting larger denominations into circulation probably would be magnified.

There is little prospect of any slowing down of the rate of inflation. The inventory position for many raw materials in Shanghai appears to be tighter now than a year ago, but the Government's import controls, as has been mentioned, are increasingly restrictive. Difficulties are being encountered in maintaining an adequate flow of coal from North China mines to Shanghai. Factors such as these will keep the speculative markets in ferment. There is no prospect of military outlays tapering off nor, therefore, is there any likelihood of an approach to a balanced budget. The underlying causes of inflation remain the same.

A new danger is disruption of Shanghai industry through lack of materials, should the Government find it necessary to cut down still further on imports as its dollar reserves approach exhaustion. This additional impetus to accelerated inflation may, however, be obviated by a credit from the United States of the magnitude tentatively suggested by Secretary Marshall on November 12. But it is questionable whether such economic assistance as this can restore a degree of confidence in the Chinese currency sufficient to bring any slowing down of the rate of inflation.

ARGENTINE POLICIES ON INTERNATIONAL CAPITAL MOVEMENTS

David L. Grove and
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During the war years, Argentina was preoccupied with the inflationary effects of the large inflow of foreign capital which the country was experiencing. This concern led to the adoption of measures in 1943 to restrict the entry of foreign funds except for purposes of investment in industry or agriculture. By mid-1947, however, Argentina had become much more concerned about its dwindling international reserves than about the inflationary impact of incoming exchange. As a consequence, a new policy has been adopted which removes most restrictions on capital entry and endeavors to attract foreign funds by holding out certain guarantees with respect to the remittance of profits earned on foreign capital invested in Argentina.

Capital Inflow During the War

The chief impact of the war on the Argentine economy was to produce a highly favorable balance of payments for a country which had hereto been plagued by exchange shortages. From 1940[1] to 1943, exports increased by 42 per cent while imports dropped by 37 per cent. The inflationary impact of the monetization of balance of trade surpluses in this period was intensified by

1/ In 1940, Argentine exports exceeded imports by about 13 per cent.

a large-scale capital inflow, much of which represented European capital seeking refuge from the war.

The Argentine Government and the Central Bank adopted a number of anti-inflationary measures designed to moderate the domestic effects of the balance of payments situation. In the field of fiscal policy, income tax rates were raised, new levies were placed on excess profits and on sales of luxuries, budgetary expenditures were lowered and such expenditures as were not covered by ordinary budget revenues were financed primarily by sales of bonds to the public rather than by resorting to bank credit. Price control was adopted to the extent of placing ceilings on the prices of key commodities. By moral suasion, the Central Bank prevailed on the commercial banks to reduce the volume of new loans and to build up their cash reserves. The public, for its part, retired a portion of its indebtedness and accumulated large idle balances. That the combination of these measures was fairly effective is demonstrated by the fact that the cost of living rose only slightly.

All of the measures described up to this point refer to attempts to cushion the effect on the domestic economy of the rapid growth in the Central Bank's international reserves, rather than to check the growth. It would have been inconceivable to the Argentine authorities to combat inflation by cutting the volume of their principal exports. The Argentine economy has always been geared to the exportation of agricultural products and the shift of factors of production from agriculture to other activities would have been a slow and painful process. Moreover, the inflated value of exports during this period, coupled with the non-availability of imports, was primarily responsible for the accumulation of large foreign exchange reserves which, it was hoped, would make possible substantial fulfillment of Argentina's cherished dream of industrialization and financial independence.

There was one element in the Argentine balance of payments, however, which the authorities felt could and should be controlled; namely, the large amount of refugee capital which was pouring into the country. Argentina welcomed such capital whenever it was directed toward investment in industry or agriculture, but viewed with some alarm the inward stream of funds seeking investment in securities or real estate. There was concern that such funds were merely seeking a temporary resting place and would depart once the war was over. In the meantime, they would not have contributed to Argentine capital formation but would have served merely to inflate the price of securities and real estate, thereby blowing up a bubble which would burst as soon as the capital prepared to depart.

Introduction of Capital Import Controls

On April 12, 1943, a decree was issued the purpose of which was declared to be to establish a system of control to check the inflow of "speculative" capital while at the same time facilitating the entrance of foreign capital seeking permanent investment in industry and agriculture. The Central Bank was given the responsibility for administering the system and for giving substance to the general principles set forth in the above-mentioned decree. This substance was provided by the Bank's circular No. 333 of May 12, 1943, entitled "Regulations Covering Movements of Funds Abroad and Operations for the Account of Persons Domiciled or Resident Abroad".

The circular provided that all inward remittances of funds from abroad involving amounts greater than one thousand pesos (approximately US$250) would thenceforth require prior approval, which could be obtained only upon submission of a sworn declaration describing in detail the purposes for which the funds were to be employed. In all cases where remittances did not represent capital transfers, any institution officially licensed to deal in foreign exchange might grant the necessary authorization. Only the Central Bank, however, might grant authorization in instances involving capital transfers. Thus, the entry of all foreign capital was subjected to the scrutiny of the Central Bank which permitted such entry only upon demonstration that there would be a contribution to real capital formation and that the funds would not be used for purely speculative purposes.

The new regulations were followed by a marked reduction in the inward flow of foreign capital. For the period January through April of 1943, prior to the adoption of restrictions, capital imports had amounted to 73 million pesos (equivalent to an annual rate of 219 million). From May to December, after the introduction of controls, only 80 million pesos entered (equivalent to an annual rate of 120 million). During the following year, 1944, capital imports were comparatively small, amounting to only 68 million pesos.

It is difficult to judge the extent to which this reduction can be attributed to the measures adopted. For one thing, the difficulties of transferring capital from Europe had already become almost insurmountable by the early part of 1943 and consequently, even without Argentine restrictions on entry, the volume of inward remittances would undoubtedly have declined sharply. What is likely is that the controls did not reduce the volume of capital imports significantly but rather had some effect on the character of the investment of funds entering the country.

If the capital accounts are taken in their entirety, it is observed that from 1943 onward Argentina passed from a situation of large net capital imports to one of moderate net capital exports.1/ The transition came at the end of the first four months of 1943, although for that year as a whole there was a small net inflow of capital. The reversal of a net inward movement of capital to a net outward movement was due only in part to the decline in incoming remittances; an acceleration of capital exports occurred between April and December of 1943 and although capital exports declined somewhat in 1945, they nevertheless remained at a high level. During this period, Argentina placed few obstacles in the path of capital exports, funds for which could be purchased in the free exchange market without limit.

Despite the deficit on capital account in 1944 and 1945, Argentina's international reserves continued to increase as a result of a tremendous export surplus.

Postwar Developments and Restrictions on Capital Outflows

Since the close of World War II, Argentina has embarked upon a broad economic program which has placed a severe strain on its international reserves. The proposed purchase of the British railways and the importation of machinery and materials needed for the industrialization program of the Five-Year Plan will draw heavily upon Argentina's foreign financial resources. In order to check outflows of exchange not considered essential to the fulfillment of the official economic program, importation of an increasing number of items has been suspended or subjected to limited quotas.

1/ For the years 1940 to 1943, inclusive, Argentina had net capital imports of 79, 325, 235 and 29 million pesos, respectively, and for the years 1944 and 1945 had net capital exports of 43 and 112 million pesos.

In order to expand the receipt of foreign exchange, a government-owned trade monopoly called the Instituto Argentino de Promocion del Intercambio was established in the latter part of 1946. This action was followed in July 1947 by a revocation of all previous regulations restricting the free entry of foreign capital and by the promulgation of limitations on the export of capital, both Argentine and foreign. The new policy with respect to capital movements is contained in the Central Bank Circular No. 788 of July 8, 1947. The Circular provides that capital may freely enter Argentina, the only requisite being a sworn declaration of entrance on the appropriate forms. In cases where the incoming capital is to be invested, the sworn declaration must include a statement of the country of residence of the investor, the proposed type of investment and its duration. On the basis of this information, the Central Bank will issue a "Certificate of Origin of Capital" which will ensure the remittance of earnings and principal according to an established schedule. Despite the general removal of restrictions on incoming capital, the entry of capital from countries with which Argentina has clearing agreements (Belgium, France, Spain and Switzerland) and of capital to be invested for a period of more than six years still requires prior authorization by the Central Bank.

The remittance of service payments on foreign capital will be permitted in accordance with the schedule presented below.

Nature of Investment	Duration	Interest or Dividend not Exceeding: a/ (per cent per annum)
Short-term		
Various Investments	Up to 12 months	5
Medium-term b/		
Fixed investments in industry or agriculture	Up to 2 years	7
	" " 3 "	8
	" " 4 "	9
	" " 5 "	10
	" " 6 "	12
Long-term	Over 6 years	Subject to contractual agreement with Central Bank c/

a/ Profits exceeding these percentages are considered as Argentine capital and their remittance abroad is subject to the same requirements as are remittances of Argentine capital.

b/ Application for reinvestment of medium-term capital may be made before the original specified duration of the investment has expired, provided that at least two years have elapsed.

c/ Such contracts must contain a clause permitting participation of Argentine capital.

It will be observed that the longer the period of investment, the higher the rate of profit which may be remitted. Although the rate pattern for long-term investments has not been announced, and will probably vary from case to case, the presumption is that it will be at least as large as that of six-year investments (i.e., 12 per cent). This would be in keeping with Argentina's policy of encouraging foreign capital to invest in long-run undertakings, rather than seek quick profits and then depart.

Upon the termination of the specified period of investment, the exact amount of foreign capital registered upon entry may be transferred abroad. The transfer of capital gains or accumulated profits will not enjoy the guarantee provided under the schedule presented above. Such balances may, of course, be retained by the owner but will be treated as "Argentine" capital. The remittance of foreign capital already invested in Argentina prior to the issuing of Circular 788 may be effected only upon proof by the owner that the investment is really foreign and not domestic.

Exports of "Argentine" capital may be made only on the authorization of the Central Bank, after recommendation by the Mixed Capital Institute for Securities Investment (Instituto Mixto de Inversiones Mobilarios) that such transfer would be in the national interest, and especially in the interest of the domestic securities market.

Conclusions

Insufficient time has elapsed to permit any evaluation of the effects of the recent regulations governing Argentine capital movements. Nevertheless, the purposes of the regulations appear quite clear. First, through the offer of specific guarantees on the remittance of principal and earnings, an attempt is being made to encourage the entry of foreign capital, particularly for investment in long-term projects. Secondly, an effort is being made to prevent "exploitation" by foreign capital through the setting of ceilings on the amount of profit which may be transferred abroad. Thirdly, pressure will be placed on foreign investors to permit Argentine participation in all long-term projects.

The new measures may possibly attract some foreign capital for long-term investment because the guaranteed rate of remittance of profits on such investments will probably not be less than 12 per cent which, in conjunction with guarantees on the remittance of principal, should normally be quite satisfactory to most investors. The guaranteed rates for transfer of earnings on short and medium-term investments, on the other hand, may not be considered sufficiently high to attract potential investors, despite the assurance of being able to transfer the principal at the end of the specified period.

The position of foreign-owned banks and firms already established in Argentina is likely to be rather uncomfortable as a result of the new measures. First of all, they must go through the administrative difficulties of effectively proving their foreign status. Secondly, their bargaining power in the negotiation of contracts with the Central Bank will be impaired by the fact that their funds are already in the country. Foreign-owned importing and exporting firms will be particularly hard hit, judging by one of the statements in a Central Bank press release which declared that the net profits from all foreign trade transactions, regardless of the origin of the capital of the firm engaged in the operation, would be considered as earnings on Argentine capital and their transfer abroad would be governed accordingly.

Existing foreign owners of short- and medium-term investments are especially likely to discover that the new rates applicable to the remittance of profits on their investments are less than what they have habitually earned and transferred abroad in the past.

The new policy may well force an accumulation in Argentina of substantial sums of foreign-owned profits. The dissatisfaction of many of the existing foreign investors in Argentina and the increasing encroachment of the Government upon private enterprise, particularly through the Trade Promotion Institute may well discourage new foreign investment to an extent which cannot be offset substantially by the limited guarantees recently established.