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Board of Governors of the Federal Reserve System

Division of International Finance

REVIEW OF FOREIGN DEVELOPMENTS

October 24, 1950

Post-Korean Boom in Dollar Prices of Sterling Area Exports By Samuel I. Katz	5 Pages
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POST-KOREAN BOOM IN DOLLAR PRICES OF STERLING AREA EXPORTS

Samuel I. Katz

Dollar prices in U. S. markets for primary products exported by sterling area countries increased throughout the second quarter of 1950 ^{1/} but rose much more sharply after the invasion of South Korea. Average prices of eight major raw material exports rose about 71 per cent during the third quarter as compared with a rise of 17 per cent during the preceding three months. During the first eight months of 1950, the quantity of U. S. imports of these products was maintained at a relatively high level and values rose moderately throughout the period. There is evidence that U. S. import values have not yet reflected the mid-1950 boom in spot prices. With rising unit values and a high level of U. S. industrial activity in prospect, raw material sales by the outer sterling countries should continue to bolster Britain's reserve position during the next six months. Since American importers have been making substantial anticipatory spot and forward purchases of sterling, it appears likely that some part of the dollars to be earned through future imports may already be gathered into the central reserves of the sterling area.

The 71 per cent rise in the prices of raw materials exported by the sterling area, which took place between June 24 and October 14, brought the eight-commodity index to a level nearly 74 per cent above the average for the year 1948 as shown in Table I.

Table I

United States Prices of Eight Raw
Materials Exported by the Sterling Area

Eight Commodity Index
(1948=100)

Item	March 25, 1950	June 24, 1950	Percent Change	June 24, 1950	October 14, 1950	Percent Change
Burlap	91.9	87.6	- 4.7	87.6	166.1	+ 89.6 ✓
Cocoa beans	57.1	76.2	+33.5 ✓	76.2	93.2	+ 22.3
Jute	78.9	83.8	+ 6.2	83.8	76.2	- 9.1
Rubber	90.4	130.4	+44.2 ✓	130.4	286.7	+119.9 ✓
Tin	77.9	77.4	- .6	77.4	111.7	+ 44.3
Tea	90.9	79.8	-12.2	79.8	91.5	+ 14.7
Wool	98.9	111.9	+13.1 ✓	111.9	155.6	+ 39.1
Goatskins	105.0	101.1	- 3.7	101.1	109.0	+ 7.8
Eight Commodity Index	86.9 ✓	101.6	+16.9	101.6	173.5	+ 70.8

Source: Division of Research and Statistics, Board of Governors of
Federal Reserve System.

^{1/} See "A Note on Post-Devaluation Dollar Prices of Sterling Area Exports,"
this Review, June 6, 1950.

The outstanding development during the third quarter was the more than 100 per cent rise in rubber prices following a 44 per cent rise during the second quarter; on October 14, the rubber index was nearly three times the average for 1948. Other major third-quarter price increases included rises of 90 per cent for burlap, 44 per cent for tin and 39 per cent for wool. Following a 34 per cent rise during the second quarter, the price of cocoa beans rose an additional 22 per cent in the last three months. The 15 per cent rise in tea followed a comparable decline during the previous quarter.

The mid-1950 expansion of U. S. purchases of these products, as reflected in the quantity and value of imports, has been equally striking. Both the quantity and the value of U. S. imports of the eight raw materials from the sterling area were well maintained during the three-month period, June to August, as shown in Table II. An index of the physical volume of imports, based on 1948 as 100, shows the volume of U. S. imports for the June-August period at 105 or nearly 10 per cent above the previous post-war high recorded for the same period in 1948. A substantial expansion in the value of U. S. imports also occurred during the June-August period although at 97.9 the 1950 figure was only slightly above the previous high of 94.8 for 1948.

Table II

United States Imports, Quantity and Value of Eight
Major Raw Materials Exported by the Sterling Area
(1948=100)

Period	January a)	April a)	July a)	October a)
I. Quantity:				
1947	-	124.3	89.7	81.8
1948	129.8	110.9	95.3 ✓	69.2
1949	99.2	99.0	68.2	72.5
1950	107.7	-106.3	-105.2 ✓	
II. Value:				
1947	-	101.4	75.5	69.0
1948	122.0	110.8	94.8	73.1
1949	100.9	94.9	60.6	65.9
1950	82.3	+88.6	+97.9 ✓	

Source: Division of International Finance, Board of
Governors of the Federal Reserve System.

a) Middle month in which three-months moving average
is centered.

Since February 1950, however, the quantity index has actually been declining slightly while the value of U. S. imports has risen from 82.3 in January to 97.9 in July. This sustained expansion in value reflects the upward trend in dollar prices of these products from the post-devaluation lows of November 1949.

Chart A on page 5 brings together the index of monthly spot prices and the moving-average indexes of import quantity and value for the period since July 1947. It will be noted that the value index fell sharply below the quantity index in the second quarter of 1949, reflecting the sustained decline in prices which occurred after August 1948. After the September 1949 devaluation, the gap between the two indexes widened substantially, as the value expanded more slowly than the quantity of imports. This gap reached a maximum in January 1950 but since then the value has been rising despite the declining volume of imports and the gap has narrowed perceptibly.

Although the bottom of the monthly price index was reached in November 1949, the maximum gap between the value and quantity series did not occur until early in 1950. Hence, after devaluation, there was a time-lag of three to four months before the upturn in the price index was reflected in a more rapid rise in value than in quantity.

Given a time-lag between prices and import value, the enormous rise in the monthly price index since June 1950 is grounds for the expectation that the value index should continue to move upward, at least in relation to the quantity index. Data on unit values of U. S. imports for five of these primary products summarized in Table III do not reflect increases comparable to the rise in prices shown in the spot figures.^{1/}

Table III

Unit Values of United States Imports of Specified Exports By
Sterling Area, January to July, 1950.
(in cents per pound)

Month	Burlap (India)	Cocoa beans (Gold) (Coast)	Rubber (British) (Malaya)	Tin Bars (British) (Malaya)	Combing Wool (Australia)
January	20.5	15.3	15.2	79.3	105.
February	20.4	19.4	15.6	71.3	116.
March	19.7	21.7	16.3	71.5	115.
April	20.2	22.7	17.1	71.5	132.
May	20.3	21.6	17.3	71.8	131.
June	21.4	22.2	19.3	73.3	139.
July	21.7	24.9	21.2	76.7	136.

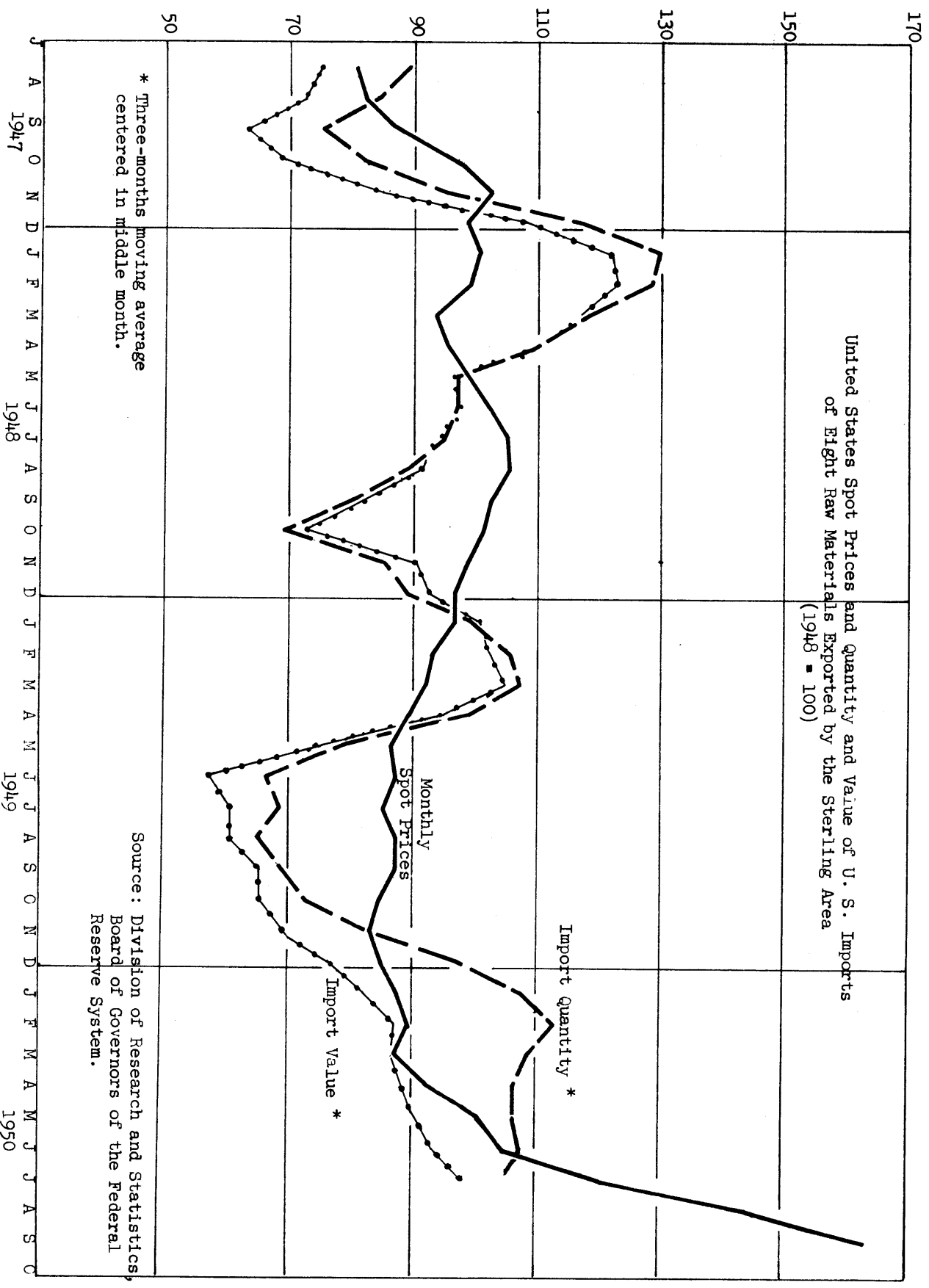
^{1/} The unit value figures are not strictly price data since they are based on declared import value and in certain cases may reflect statutory valuation requirements rather than the actual prices paid by the importer. Further, unit value is obtained by dividing total value by total quantity; the month-to-month changes in the quality and type of imports make data on unit value unreliable as an indication of actual price movements. Despite these qualifications, however, the limited unit value increases from March to July suggest that second and third quarter price rises have not yet been fully reflected in the statistics on import value.

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If, then, there is justification for the expectation that the value will continue to rise relative to the quantity index, there remains the question of the direction in which the quantity index can be expected to move. Inspection of the chart shows, for the past three years, a sharp seasonal decline in the quantity series during the months, April to October, but the decline thus far in 1950 has been quite gentle. Previously, the volume of imports reached a low point during the fall months, usually around September or October, and then expanded sharply to peaks during the early part of the subsequent year. The abnormally high level of imports during mid-1950 reflects, of course, the post-Korean increase in U. S. demand for these raw materials. As a result of post-Korean developments, there is some question whether any sharp decline in our imports will take place this fall. In any case, sterling area sales of raw materials to this country are likely to be maintained, at least during the next six months, as a result of the defense program and the expected levels of industrial production. This active American demand has already been reflected in substantial anticipatory spot and forward purchases of sterling by American importers; as a result, some part of the dollar earnings from future U. S. imports of these primary products may already be gathered into the central gold and dollar reserves of the sterling area.

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United States Spot Prices and Quantity and Value of U. S. Imports of Eight Raw Materials Exported by the Sterling Area (1948 = 100)



* Three-months moving average centered in middle month.

Source: Division of Research and Statistics, Board of Governors of the Federal Reserve System.

October 24, 1950

RECENT MONETARY DEVELOPMENTS IN AUSTRALIA

Samuel I. Katz

Despite a rigorous centralization of monetary authority and the use of monetary controls of a radical character, Australia has undergone a sustained inflation during the post-war period. The rate of expansion was accelerated during 1949-50, and a further increase might well be expected as a result of the post-Korean boom in world prices of certain major Australian exports and of the vigorous current domestic investment programs of business and government. Large external surpluses, largely the result of heavy inflows of capital, were the major inflationary factors during 1947-48 and 1948-49; renewed government borrowing from the banking system was an additional, though less important, source of monetary expansion during the past fiscal year. Although stringent control over commercial banking has been possible through the establishment of a novel Special Accounts system, the authorities have not been able to effect internal stabilisation. On the basis of this experience, it would appear that there are limitations to the effectiveness of the devices developed in Australia as instruments of monetary control. Restrictive control over commercial bank lending has not been sufficient in itself to keep in check strong external and domestic inflationary pressures.

Wartime changes in the Australian banking system

The structure of banking in Australia was greatly altered during the war period. A degree of authority over the operations of the commercial banks, considerably greater than the powers generally allocated to the central bank, was delegated to the Commonwealth Bank by the Labor government. At the same time, the Commonwealth Bank was effectively brought under Treasury direction. This centralization of authority, initiated early in the war and continued into the post-war period through the enactment of permanent legislation in 1945, is largely to be explained by the reliance placed upon the control of banking by a Labor government. Such control was regarded as a major anti-inflationary weapon and as an essential instrument for directing the entire economy, particularly in maintaining full employment.

This wartime delegation of authority contrasted markedly with the Bank's uncertain position in the inter-war period. The Bank, which had been established in 1911 as a national bank by a Labor government, was designed originally to compete with the nine trading banks which dominated commercial banking. Only gradually did it begin to assume central banking responsibilities. The slow evolution of its central banking functions is explained in part by the political controversy which has surrounded the Bank throughout its existence. The Labor party tended to emphasize its competitive role, while conservative (non-Labor) governments, which were in power during most of the inter-war period, "encouraged the authorities of the Bank in their proclivity to keep clear of active competition and to approach, at no unseemly

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speed, the goal of accepted central banking."^{1/}

An inquiry into Australian banking by a Royal Commission during 1937 noted that the Commonwealth Bank's control over the lending operations of the commercial banks was unsatisfactory. The Commission's recommendations and the subsequent controversy provide the background for the drastic centralization of Australian banking authority which occurred during the war.

As the Commission pointed out, the banks did not adhere to rigid cash ratios but allowed these ratios to vary considerably from time to time.^{2/} Further, the accounts maintained by the banks at the central bank were in large measure for clearing purposes and consisted of only one part of their cash reserves. To remedy this situation, the Commonwealth Bank's Board recommended to the Commission that the commercial banks be required by law to keep a fixed proportion of their liabilities with the Bank; otherwise, it was argued, the banks would hold their funds not with the Bank but in treasury bills or in London. The commercial banks were unanimously opposed to any such minimum reserve requirement.

On the other hand, the compromise recommended by the Commission satisfied neither the commercial banks nor the monetary authorities. The Commission rejected as unnecessary the request for permanent legal reserve requirements but stated that, for temporary periods, the Bank should have additional authority to enforce its credit policies upon the commercial banks.^{3/} The grant of authority was substantial, giving the central bank authority to prescribe uniform reserves for all commercial banks, within limits approved by the Treasurer. Two major restrictions, however, were placed upon this power: prior permission of the Treasurer was necessary to put reserve requirements into effect and the authority was strictly limited in time. An original authorization would be valid only for six months, but the Treasurer could extend it an additional 12 months; in any two-year period, however, the power could be exercised for no more than 18 months.

The Commission's recommendation had not been acted upon when hostilities broke out in Europe, but its Report stimulated controversy over statutory reserve requirements. Reflecting the feeling engendered, the major commercial bank in 1939 allowed its balances at the Bank "to contract to a microscopic size."^{4/}

^{1/} A. F. W. Plumptre, Central Banking in the British Dominions, pp. 88-89.

^{2/} Report of Royal Commission on Monetary and Banking Systems in Australia, July 1937, especially p. 226 (Para. 584).

^{3/} Report of Royal Commission, pp. 228-9, especially pars. 588 and 589.

^{4/} Plumptre, op. cit., p. 276.

In the early days of Australia's war mobilization, the Treasury borrowed from the central bank to meet its short-term needs. Because of the danger that the increased liquidity of the commercial banks would generate an undesirable secondary monetary expansion - a danger aggravated by the Treasury's continued dependence upon the Commonwealth Bank for short-term funds - the government initiated a step which was to have historic consequences. In his budget speech in September 1941, the Commonwealth Treasurer outlined a new system of special wartime commercial bank deposits required to be held at the Commonwealth Bank:

"Our finance in the next few months will require a good deal of temporary accommodation, and a necessary precautionary measure will be to remove any danger of secondary expansion by the trading banks, and so guard against any excess banking profits. I have given a good deal of consideration to the question of the best method of doing so. My conclusion is that the most effective measure is to require the banks to keep in a special deposit account with the Commonwealth Bank any increase in their funds due to war finance."^{1/}

Agreement to this special deposit system was the principal point in a general undertaking voluntarily accepted by the commercial banks at the behest of the Treasury.^{2/} The agreement provided that "all investible funds" of the commercial banks would be maintained in special deposits at the central bank. These deposits were to be temporary, for six months duration, but renewable upon maturity at the Bank's discretion. The Treasurer considered this wartime deposit procedure a "variation of the method proposed by the Royal Commission"; the proposed arrangement was also related to the Treasury Deposit Receipt system which had been initially introduced in the United Kingdom in July 1940.^{3/}

The voluntary undertaking of the commercial banks was never implemented, however, because the conservative (Liberal) government was defeated. In order to effect a more rigorous control of profits, the Labor government which then took office established a more strict definition of surplus funds than had been written into the earlier agreement and made the deposits mandatory under a licensing regulation. In place of the loose

^{1/} Quoted in The Australasian Insurance and Banking Record (henceforth termed Insurance Record), October 21, 1941, p. 411.

^{2/} See Insurance Record, October 21, 1941, p. 411 for the full text of the "Terms of Undertaking by Trading Banks."

^{3/} A discussion of Britain's Treasury Deposit Receipt system will be found in this Review, June 6, 1950, pp. 2-3.

wording "all funds over and above those necessary to enable the banks to meet the overdraft requirements of the public", "surplus funds" in the new regulation were defined specifically as "the amount by which a bank's total assets in Australia exceeded the level for August 1939."^{1/} Under this definition, 100 per cent reserve deposits were required for all deposits above the pre-war volume. The six-months (renewable) term of the deposits provided in the voluntary agreement was abandoned.

The effect of these more rigorous regulations upon commercial banking operations during the war can be seen from Table I. Although total deposits expanded from £A 317 million in July 1939 to £A 572 million in July 1945, outstanding advances actually contracted from £A 294 million to £A 212 million. As a result, advances represented only 37 per cent of deposits in 1945 compared with 93 per cent in 1939. The sharp changes shown in Table I in the distribution of commercial bank assets were largely the result of the large special wartime deposits maintained at the Commonwealth Bank; it will be noted that, by July 1945, the amount of these deposits slightly exceeded the total of loans outstanding.

Table I.

Australia - Deposits and Assets of the Nine Trading Banks
July, 1939 and 1945

	July 1939		July 1945		Change between 1939 and 1945
	Amount	Per cent of deposits	Amount	Per cent of deposits	Amount
	(millions of £A)		(millions of £A)		(millions of £A)
Deposits	317	-	572	-	+255
Liquid assets in Australia	51	16.1	78	13.6	+27
Government securities	22	6.9	104	18.2	+82
Advances	294	92.7	212	37.1	-82
Special Accounts	0	0	234	40.9	+234

Source: Report of Commonwealth Bank for year ended June 30, 1949, p. 32.

^{1/} The text of "Regulations for Control of Banking" is found in the Insurance Record, December 22, 1941, p. 515.

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The war-time innovations became particularly significant when, on the basis of the war experience, the Labor government decided to make them permanent features of Australian banking. To this end, the government introduced the Commonwealth Bank Act and the Banking Act of 1945 which permanently altered the country's banking structure.

The Banking Act of 1945 established a system of Special Accounts with the central bank for commercial banks and transferred to these accounts the balances remaining of the war-time special deposits. Further, the Commonwealth Bank was empowered to approve purchases and sales of government securities by the banks and to make "regulations controlling rates of interest in respect to advances made by the banks, deposits made with the banks, or rates of discount chargeable by banks, or any other person, in the course of banking business."^{1/}

Noteworthy in the Commonwealth Bank Bill of 1945 was the absolute subordination of the Bank to the Treasurer provided for in the legislation. In cases of Treasury-central bank controversy, the law provided that, if the Treasurer informed the Bank that the government accepted responsibility for the adoption by the Bank of a government-approved policy, the Bank must "then give effect to that policy."^{2/} In addition, gold and foreign exchange reserves were no longer to be kept against the note issue. This step was justified on the grounds that "more emphasis needs to be placed on the control over that part of the credit base which consists of deposits with the central bank, rather than over the note issue, which is only a reflection of credit policy."^{3/}

With the passage of these two pieces of legislation, the monetary authorities in Australia entered the post-war period with extensive authority over commercial banking and with broad administrative discretion in their use of the powers granted.

^{1/} Insurance Record, March 21, 1945, pp. 99-100.

^{2/} Commonwealth Bank Act, 1945, Part II, Section 9.

^{3/} Speech of Treasurer Chifly reproduced in Insurance Record, March 21, 1945, p. 97. It should be noted that the Royal Commission had recommended that statutory reserves against the note issue be eliminated and that the issue be limited by law to a fixed maximum (similar to arrangements currently prevailing in the United Kingdom); but the Treasurer argued that the establishment of a maximum was inappropriate at the time in view of "the expansion of the note issue during the war."

The Special Account as an instrument of monetary control

During the war period, the Special Accounts were used to immobilize the additional bank reserves which were created through central bank accommodation to the Treasury. Between July 1939 and July 1945, the deposits of the commercial banks had increased by £A 255 million, as shown in Table I, but some £A 234 million had been called up into the Special Accounts. It was during this war period that the Special Account procedure operated virtually as an experiment in 100 per cent reserve banking.

With the end of hostilities, it was clear that the rigorous curtailment of bank lending imposed during the war through the Accounts would have to be relaxed if the banks were to provide funds to finance industry's peacetime requirements. The liquidity of the banks was increased, in part, by allowing them to dispose of war-accumulated government securities; these were a source of reserves independent of their special deposits. At the same time, the authorities substantially reduced the proportion of new assets called into the Special Accounts: in fact, between July 1945 and July 1948, the Commonwealth Bank called up only about 45 per cent of new deposits.^{1/} Because the rate at which the commercial banks expanded their loans was uneven, however, certain banks found by the middle of 1947 that their security holdings were at a low level. Hence, they requested that the Bank permit releases from their Special Accounts.

Following these requests, the Bank introduced greater flexibility in the procedure without, however, making releases from the Accounts. Flexibility was attained by allowing the banks to obtain short-term loans from the central bank at a 3-1/2 per cent rate. Through this temporary accommodation, the commercial banks were given time to adjust their lending policies and were not forced to refuse essential requests for loans by their customers. With this innovation, therefore, a penalty rate at which commercial banks could obtain urgently required reserve funds was introduced into the monetary organization. This device was for purely short-term accommodation, however, because the authorities insisted that the growth requirements of the economy were to be financed by releases from the Special Accounts and that the releases would be authorized on a scale sufficient to support a level of bank lending deemed by the authorities to be appropriate. The Bank made it clear that the commercial banks "will be expected to adjust their operations so as to conform to this general level."^{2/}

1/ Report of Commonwealth Bank for year ended June 30, 1949, p. 30.

2/ Ibid, p. 32.

During the war, the Treasury had to depend upon the central bank for short-term accommodation. Had the 100 per cent call-up against new deposits not been in force, the resultant expansion in central bank credit would have produced a substantial secondary deposit expansion. Since the called-up funds remained to the credit of the commercial banks, the amounts in the Special Accounts were so large when the war ended that release of the funds was not a practical alternative. In this sense, the Special Accounts system tended to be self-perpetuating. The system also tended to block the development of an active money market by impounding banking funds which might, under other circumstances, have become available to support such a market.^{1/}

However, during the war period when Treasury borrowing from the banking system was the major inflationary force, the Accounts facilitated the rapid return to the central bank of funds created by the banking system on behalf of the Treasury.^{2/} At that time, the public retained part of its augmented income in the form of savings deposits; these funds were returned rapidly to the Treasury as the savings banks made bond purchases. To ensure the rapid collection of funds deposited with the commercial banks was a major function of the Special Accounts.

Immediately after the war, the principal source of monetary expansion shifted to the extension of advances by the commercial banks. To facilitate the conversion to peacetime production, the authorities reduced the proportion called up against new deposits. To offset this expansion in private credit, the authorities reduced government borrowing from the banking system.

When, after mid-1948, the primary source of inflationary pressure was the rapid rise in Australia's foreign exchange holdings (London funds), the Accounts did not, nor were they designed to, sterilize the inflow of funds. A rise in London funds expands deposits in Australia, whether the increase comes from heavier export earnings or capital inflow. Such an increase means that Australian banks sell Australian pounds and buy foreign currency, in the first stage, by the creation of deposits in favor of the foreign currency holder. A 100 per cent Special Account call-up prevents a multiple deposit expansion but not the primary increase: it cannot be used to sterilize an influx of foreign funds.

^{1/} See Plumptre, op. cit., pp. 82-3 and "Influences in Australian Banking" in Financial Times, International Banking Supplement, April 24, 1950, p.x.i.

^{2/} In England the funds accumulated through the Treasury Deposit Receipt went to the Treasury's account and not to the credit of the commercial bank in reserve deposits at the Bank of England; this was a major difference between Britain's Deposit Receipt and Australia's Special Accounts.

Purchase of foreign exchange by the central bank increases the reserve deposits of the commercial banks; this expansion in central bank credit comes into being not at the initiative of the monetary authorities but as the capricious consequence of a favorable foreign balance. Despite their formidable array of power, therefore, the Australian monetary authorities were unable to control or effectively offset the movement in London funds by means of the Special Accounts.^{1/} This difficulty continues to be the major source of weakness in their control over the internal money supply.

In this connection, it is interesting to note that the authorities have a greater degree of freedom in using the Accounts to offset a decline in London funds than to counter the effects of a rise. A fall in London funds leads to a contraction in deposits and in the Special Accounts of the commercial banks; on the other hand, a rise in London funds leads to an expansion in deposits and in the Special Accounts. The contraction in deposits accompanying a fall in London funds can be offset by a release of reserves to the commercial banks from their Special Accounts; the effectiveness of such an offset would, of course, be governed by the public's willingness to borrow. The Special Accounts procedure could, however, eliminate the deposit expansion accompanying a rise in London funds only if the banks were forced to reduce other earning assets through the call-up to the Accounts of more than 100 per cent.

A limitation of the Special Accounts in coping with an expansion due to an external surplus is illustrated in Table II where the initial monetary effects of a £A 10 million rise in London funds are shown under assumptions of a 100 per cent reserve ratio (Case A), central bank sales of securities to the banking system (Case B) and central bank sales to the public (Case C).^{2/} Only under Case C assumptions is the capital inflow completely sterilized: the central bank's assets are not enlarged and the balance sheet of the commercial banks is undisturbed. The monetary effects are substantial, however, in Cases A and B. The major difference between these two cases illustrates the significance of the Special Accounts. It will be seen that additional high-powered money is created in Case A but that these reserve funds are effectively impounded by means of the Accounts. Despite the expansion in the central bank's assets in Case A and not in Case B, therefore, the expansion in the assets and liabilities of the commercial banks is the same in the two cases.

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- ^{1/} The authorities would, of course, be confronted with identical difficulties in the case where a Treasury deficit were financed by central bank credit; but the resultant expansion in high-powered money would in normal times presumably be the deliberate objective of Treasury policy.
- ^{2/} An expansion due to a Treasury deficit financed initially by the central bank would, of course, produce an identical growth in the money supply under each of the three assumptions.

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Table II.

Monetary Effects Resulting from an Increase of £A 10 Million
in London Funds under Hypothetical Conditions
(In millions of £A)

	Case A <u>a/</u>	Case B <u>b/</u>	Case C <u>c/</u>
<u>I. Central bank:</u>			
<u>Assets:</u>			
Foreign exchange	+10	+10	+10
Securities		-10	-10
<u>Liabilities:</u>			
Special Accounts or reserve balances	+10	-	-
<u>II. Commercial banks</u>			
<u>Assets:</u>			
Securities	-	+10	-
Special Accounts or reserve balances	+10	-	-
Loans			
<u>Liabilities:</u>			
Deposits	+10	+10	-
<u>III. Holdings of public:</u>			
Deposits	+10	+10	
Securities	-	-	+10

a/ 100 per cent call-up to Special Account.

b/ Central bank sale of bonds to commercial banks.

c/ Central bank sale of bonds to public.

The fact that the deposits of the public are enlarged in Case A points to an additional major limitation of the Accounts as a device of monetary control; despite the Accounts, the expansion in money incomes continues to have a multiplier effect on Australia's domestic income. Higher incomes increase the demand for loans and intensify the difficulty faced by the monetary authority in holding bank lending in check, since the number of loan requests from good customers will grow as incomes move to higher levels.

In a technical sense, these limitations are weaknesses of the Special Accounts as an instrument of monetary technique but, more broadly, they illustrated the limited effectiveness of a stringent control over commercial bank lending unsupported by supplementary measures, particularly in the monetary and fiscal field. For example, the inflation growing out of

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higher export earnings could be restrained by means of a more rigorous fiscal policy, by enlarged private purchases of bonds from the central bank or by currency appreciation. Any of these steps would bolster, and in no way interfere with, the effectiveness of the Special Accounts. Nonetheless, the Accounts should be recognized primarily as a device to control commercial bank lending; they are not designed to absorb credit created by the central bank (either to purchase foreign exchange or to finance a Treasury deficit) or to negate the pressures generated by expanding domestic incomes.

Sources of post-war monetary expansion

The progress of the post-war Australian inflation is indicated by the annual per cent changes in major statistics shown in Table III. Recently the rate of monetary expansion has accelerated, following virtual stabilization in 1946-47, and has been accompanied by substantial rises in wholesale prices and retail prices/wage rates. Until mid-1948, advances of the nine trading banks expanded more rapidly than their deposits, but since June 1948, when the foreign balances began to rise, their advances have lagged behind the increase in their non-interest bearing deposits. The important increases in the export price index occurred during 1947-48 and 1949-50. The perceptible quickening of inflationary pressure from mid-1948 to early 1950 was significant since, until just before the invasion of South Korea, a general stabilization of prices was taking place elsewhere.

Table III.
Australia - Per cent Changes in Selected Statistics
June to June Comparisons or Annual Averages
(In per cent)

	1933-39 to 1943-44	1943-44 to 1945-46	1945-46 to 1946-47	1946-47 to 1947-48	1947-48 to 1948-49	1948-49 to 1949-50
1. Total money supply	+38	+24	+ 1	+ 6	+10	+16
2. Nine trading banks:						
a. Non-interest deposits	+111	+30	+11	+10	+20	+27
b. Advances	-20	-10	+23	+26	+12	+12
3. Export price index	+14	+28	+33	+42	+16	+46
4. Import price index	+92	+ 5	+14	+16	+ 4	
5. Wholesale price index	+38	+ 1	+ 1	+11	+14	+14
6. Retail price index	+23	+ 1	+ 2	+ 6	+10	+ 6
7. Hourly wage rates	+27	+ 1	+ 6	+17	+15	

Sources: Commonwealth Bank Monthly and Monthly Review of Business Statistics, published by Commonwealth Statistician.

Item 1.- Month of June comparisons.

Items 2, 3, 4, 5, 6, 7.- Annual averages. For 1949-50, June to June comparisons have been used where the June 1950 figure is available.

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With respect to the money supply, the changes in the major sources of monetary expansion during the post-war period, based upon month of June comparisons, are shown in Table IV. In the early post-war years, a fiscal policy under which government borrowing from the banking system was reduced made possible a peace-time expansion in bank lending to business without the creation of additional funds. Up to June 1949, the annual increases in advances were virtually offset by reduced bank holdings of securities. However, the dramatic expansion in London funds, which had begun to emerge as a major inflationary force by June 1948, was not offset by a curtailment in bank lending or an additional decline in the bond holdings of the banks.

Table IV.

Australia - Annual Changes in Selected Financial Statistics
June to June
(In millions of £A)

	1946 <u>a/</u>	1947	1948	1949	1950
I. Sources of monetary expansion:					
1. Government securities	-2	-76	-26	-61	+41
2. Gold and foreign balances	+7	-17	+75	+178	+187
3. Bank advances	+21	+76	+89	+59	+91
Total change	+25	-17	+137	+176	+319
II. Assets of nine clearing banks:					
1. Cash	-	+2	+12	-6	+11
2. Treasury bills and government securities	-	-68	-17	-5	+42
3. Special Account deposits	-	+17	+18	+88	+62
4. Advances	-	+66	+59	+35	+44
Total change	-	+17	+72	+112	+159

a/ September 1945 to June 1946 only.

Sources: Commonwealth Bank, monthly and annual reports and monthly "Australian Banking Statistics" by Commonwealth Statistician.

I.1.- Security holdings of the Commonwealth Bank, the nine trading banks and all other check-paying banks.

I.2.- Holdings of all banks on last Wednesday in June; these figures tend to be larger than the average for the month of June.

I.3.- Advances of nine clearing banks and other check-paying banks.

The accelerated monetary expansion during the past fiscal year is particularly striking. Not only did London funds rise sharply, but the Treasury resumed borrowing from the banking system, after three years of debt reduction, and private bank lending expanded slightly. The credit expansion in 1949-50 from internal sources is attributed to the "high and rising level of business activity" and a doubling of capital expenditures by the government.

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The flexibility with which the Special Accounts have been used to control private lending is seen in the annual (month of June) changes in the assets of the nine large commercial banks shown in the lower half of Table IV. Up to mid-1948, bank lending was encouraged and the annual increases in the Accounts was small compared to the expansion in bank advances; thereafter, as London funds rose rapidly, the authorities became more restrictive. During 1949 and 1950 the additions to the Accounts exceeded new bank advances. Since mid-1948, in fact, the year-to-year increases in bank lending have not been a major source of monetary expansion. Equally significant, the recent resumption of government borrowing emerges as the major change in the asset structure of the nine banks during 1949-50 compared to the changes during the previous year.

The problem of inflation control

With the external surplus as the principal inflationary factor, Australia has undergone a substantial monetary expansion during the last two fiscal years. The inability of the authorities to use the Special Accounts or other device to sterilize inflowing funds and the heavier demand for bank credit as incomes have risen illustrate the limitations of the Accounts as an instrument of monetary control. On the other side, however, it is significant that the huge increase in London funds has not been allowed to give rise to a large secondary expansion in deposits and that bank lending has not recently been an important source of monetary expansion.

Since mid-1948, the balance-of-payments surplus has been large. Primarily as a result of the disproportionate increase in export prices relative to import prices (the volume of trade being relatively stable), Australia earned a current-account surplus during 1948-49 of £A 33 million, had a capital inflow of around £A 167 million, and thus achieved a balance-of-payments surplus of £A 200 million. During 1949-50, a sharp increase in the volume of imports, largely from Britain and other soft-currency countries, reduced the trade surplus and produced a current-account deficit. However, the balance-of-payments surplus was maintained at a high level because of an enlarged capital inflow.

Despite the reduced trade surplus in 1949-50, export income rose by 14 per cent from £A 543 million in 1948-49 to £A 617 million in 1949-50. The higher export earnings were mainly the result of higher export prices: between the second quarter of 1949 and of this year, the export price index rose by 46 per cent; the price of wool increased by 75 per cent between September 1949 and June 1950. The continued record output of wheat, which was sold at the maximum International Wheat Agreement dollar price, led to higher incomes for wheat producers, especially after the Australian pound was devalued in September 1949.

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Another external source of inflationary pressure during the past two years has been the unprecedented inflow of foreign capital. The Commonwealth Bank estimates that during the past four year around £A 150 million out of a capital inflow of £A 450 million represents genuine capital investment. In addition, there have been short-term capital movements due to the speculative response of traders to rumors of appreciation of the Australian pound. That is, foreign purchasers have made pre-payments or transferred funds to Australia in anticipation of early purchases, while Australian importers have shown a tendency to delay payments for imports as long as possible. Despite official warning that withdrawals would be controlled, a portion of the £A 300 million is no doubt in the form of speculative funds awaiting possible appreciation. The Bank instituted on December 1, 1949, a statistical reporting system on sterling transfers (similar to reports on non-sterling movements) in order to be able to analyze better the capital flow.

Restoration of the Australian pound to parity with the British pound has been widely discussed as one method of protecting the Australian economy from these external influences. A major block on the political level to revaluation is found in the opposition of primary producers and local manufacturers.^{1/}

From a strictly economic point of view, the main arguments in favor of appreciation are: (a) the domestic monetary and income expansion resulting from higher export earnings would be reduced and the expansion from the inflow of hot money would be eliminated; and (b) the higher exchange rate would encourage heavier imports and reduce the internal cost of imported products.

Powerful economic arguments have also been raised against revaluation including the following: (a) Australia's balance-of-payments position does not warrant an appreciation; (b) the unevenness in price rises among the various export commodities means that revaluation would impose great hardship on many export producers without eliminating a large part of the recent inflationary rise in export prices for wool, lead and zinc; and (c) since Australia's inflation is also being fed from internal sources, domestic stabilization measures are more necessary than an exchange adjustment.

Evidence that Australia's external position no longer justifies currency appreciation is found in the current-account deficit realized in 1949-50 and the continued need for stringent import controls against dollar purchases at the present exchange rate. In addition, since price rises in major export commodities have been uneven, Australian exporters of products other than wool, lead and zinc would undergo substantial hardship if parity

^{1/} See, for example, "The Australian Pound Conflict," Financial Times, July 5, 1950, p. 4, and "Will the Australian Pound Be Revalued," Financial Times, September 2, 1950, p. 4.

with sterling were restored at this time; further, appreciation would concentrate the adjustment upon the export industries while other sectors of the economy would be less directly affected.

The fact that internal factors are a major source of inflationary pressure is the final objection to appreciation. Capital investment on government and private account expanded during 1949-50, and many investment plans were held back only because dollar difficulties and delayed delivery of foreign equipment made postponement necessary and because supplies of labor and materials had already been fully committed. Enlarged money incomes, which reached record levels during the past year, and the large immigration and government investment programs are in large measure responsible for the internal buoyancy.

Imposition of special export levies on certain products had been widely discussed as an alternative to currency appreciation. In mid-September there were newspaper reports of a Cabinet decision to impose taxes of at least 25 and possibly 33-1/3 per cent on wool, lead and zinc but not on wheat.

The proposed export taxes ran into opposition from the affected industries and their criticism kept alive discussion about exchange appreciation. Following the freeing of the Canadian dollar on September 30, revaluation rumors were revived and speculative purchases of Australian currency were renewed.

To bring this speculation to an end, the Prime Minister issued on October 6 a formal Cabinet denial that the currency would be appreciated. Instead, the Prime Minister announced that a broad anti-inflation program would be introduced with the new budget, including the following points: (1) imposition of a peace-time excess profits tax together with excise taxes on luxury products; (2) restoration of control over capital issues which had been removed in January 1950; (3) a 20 per cent reduction in public work expenditures; (4) curbing of bank credit for capital facilities; (5) emphasis on increased production in an attempt "to produce as much in forty hours as in forty-four"^{1/}; and (6) the granting of cost-of-living and other subsidies amounting to £A 25 million on cheese, butter, milk, tea, wheat, coal, pre-fabricated housing and woollens. In addition, the Prime Minister stated that a plan for wool would be set forth in the budget which "will be perfectly fair to wool growers but protect the rest of us."

The 1950-51 budget, introduced in Parliament on October 12, provided for sufficient additional revenue to eliminate the deficit of the previous year, despite a £A 30 million increase in defense expenditure and

^{1/} The forty-hour week was introduced into Australia following an Arbitration Court award in 1947.

£A 50 million allocated for stockpiling.^{1/} The new wool scheme provided that wool growers are to pay one-fifth of their earnings to the Taxation Department and receive credits to be available against future tax liabilities. The terms of the pre-payment scheme on wool earnings were more moderate than had been expected in many quarters and certainly cannot be considered to be equivalent, in their effect on the incomes of exporters, to a currency appreciation.

On the other hand, a decision of the Commonwealth Arbitration Court was announced on the day of the budget speech which provided for a higher basic wage and will result in general wage increases early in 1951.^{2/} In addition, the recent \$100 million World Bank loan will be used to facilitate imports of capital equipment from the dollar area and these developmental projects will make demands upon various types of Australian resources. Australia's investment expenditures, together with the announced target of 200,000 immigrants set for the current year, ensure that inflationary pressures from domestic sources will continue active during the coming year. At the same time, world prices for major Australian exports continue at high levels and heavy export earnings are in prospect. Maintenance of an external surplus should lead to a continued expansion in incomes and in money supply. By means of a rigorous application of the Special Accounts, the authorities may be able to eliminate any secondary expansion from the external surplus. Since commercial bank lending to private business has made only a modest contribution to the Australian inflation since mid-1948, the success of the anti-inflation program will, therefore, be determined primarily by the effectiveness of the new fiscal measures.

^{1/} A budget deficit of £A 25.5 million is shown for 1949-50 but transfers between current and trust accounts obscure the true picture. One analyst suspects an actual surplus of £A 2 million. (See Bank of New South Wales Review, August 1950, p. 13.)

^{2/} Australia's basic wage structure, under which wage adjustments are made by Arbitration Courts on the basis of changes in the cost-of-living, operates as a nation-wide escalator clause. By providing an automatic link between wages and cost-of-living, the system has brought about a continuous rise in money wages in the post-war period and encouraged the development of a wage-price spiral.