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Notes on the Budget of the United Kingdom............. 1
Credit Restrictions and Deflation in Italy............. 5
Problems in Appraising the Sterling Rate...............10
New Foreign Trade Policy for Bizonal Germany...........12

NOTES ON THE BUDGET OF THE UNITED KINGDOM

Robert A. Rennie

Under the provisions of the Economic Cooperation Act of 1948, each country participating in the foreign aid of the United States will undertake general commitments to achieve monetary stability and to balance its governmental budget "as soon as is practicable."1/ These objectives are essential to the process of reviving production and exports in Europe. Although the destruction of productive plant and equipment and the insufficiency of imported food and raw materials have been major causes of the European crisis, the monetary instability resulting either from a lack of balance between effective purchasing power and the goods available at controlled prices or from an outright inflationary price spiral has diminished the incentive to produce. Throughout the war and postwar periods, the deficit in government accounts has been the primary cause of the increase in the money supply of these countries. Determined efforts were made in various countries to reduce the monetary overhang in the early postwar period, but these programs were not pursued with equal vigor.

1/ Economic Cooperation Act of 1948, Public Law 472, 80th Congress, Second Session, April 3, 1948, Section 115 (b) (2).

Nevertheless, the first results of the pledges undertaken at the Paris meeting of the Committee of European Economic Cooperation with reference to monetary and fiscal measures are encouraging. Six of the sixteen ERP countries anticipate that over-all budgetary equilibrium will be achieved during the forthcoming fiscal year: the United Kingdom, Ireland, Luxembourg, Portugal, Sweden,1/ and Switzerland. Since, however, all of these countries, with the exception of the United Kingdom, suffered relatively little physical destruction and distortion in their monetary and fiscal systems during the war, there is perhaps nothing remarkable in this achievement.

But even in the countries most devastated by the war, very significant progress has been made toward achieving a sound budgetary position. In Austria, the public budget for 1948 should aid in stabilizing its financial position. Ordinary revenues and expenditures are in balance, and while the extraordinary budget shows a deficit of 597 million schillings, additional revenues of over one billion schillings will probably be collected from the proposed capital levies imposed under the Currency Protection Law of 1947. The nominal budgetary deficit in Belgium for 1948 is accounted for by the excess of extraordinary expenditure over extraordinary revenue and will be covered by a public loan. The National Bank of Belgium and the private banks extended credits of less than 3 billion francs to the Government in 1947, and the ceiling of 50 billion francs fixed by the ordinary advances of the National Bank was closely observed. Both Denmark and Norway anticipate small surpluses in their proposed current budgets, and their capital budgets have been strictly limited in consideration of the serious shortage of raw materials and labor. The fiscal position of the Netherlands, France, Italy, and Greece, while considerably less favorable than in the previous countries on account of heavier reconstruction and/or military demands, is not critical. For example, the French ordinary budget will be in equilibrium and only reconstruction and reëquipment requirements must be met from nonbudgetary sources. Part of these funds will be raised by an exceptional loan levy; the balance can undoubtedly be provided from noninflationary means of financing. The monetary and fiscal problems in these countries will be considered in greater detail in a later paper. The remainder of this article will be devoted to the fiscal policy of the United Kingdom.

The British Chancellor of the Exchequer has sought to offset the inflationary impact of excess demand arising in other sectors of the economy by budgeting for an over-all surplus of £330 million for the fiscal year 1948-49. (In the past fiscal year there was a small deficit of £14 million.) He estimated that the decline in ordinary revenues from £3,845 million in the past fiscal year to £3,765 million in 1948-49 will be more than offset by the fall in ordinary expenditures from £3,187 million to £2,976 million. There will be a total reduction in both ordinary and capital expenditures of approximately £450 million, which will undoubtedly release some productive factors to other uses and aid Sir Stafford Cripps in the achievement of his export goals. Nevertheless, it would be erroneous to assume that the Government will seek a gradual reduction of expenditures to the pre-1939 level. In 1948-49, outlays for education, health, housing, and pensions will be three and one-half times the level of 1937-38. Military expenditures, although £206 million less than last year, will be three times the prewar figure.

1/ If additional military expenditures sought by the Minister of Defense are approved, there will be a small deficit in the Swedish budget.

The anticipated gross reduction in revenue in the present year derives almost entirely from the decline in three non-tax categories. The receipts from the sale of surplus property will decline by £95 million, the income of state trading organizations will fall by £44.3 million, and miscellaneous receipts, which last year included the cancellation of unspent appropriations from previous years, will drop by £175 million. Total tax receipts, on the other hand, will rise by £243.7 million, primarily because of the anticipated higher levels of taxable income. The net revenue derived from changes in tax rates and the introduction of new taxes will be only £11.3 million.

Although there will be a general increase in total tax receipts, the income tax was again reduced. Since 1945, the remissions in this tax have amounted to £581 million, a large part of which have benefited the lower income groups. To reduce the current deterrent to overtime work which the progressively higher withholding rates imposed upon workers' wages, the income limit at which the tax first becomes payable at the 45 per cent normal rate was raised. The following schedule presents the major concessions introduced in the tax by the current budget:

Income Tax Changes in the United Kingdom Budget

		1947-48	1948-49
(a)	Initial exemption:	£120	£135
(b)	Earned income allowance:	one-sixth of the amount earned but not exceeding £250	one-fifth of the amount earned but not exceeding £400

(c) After deducting the other appropriate allowances (single person £110, married couple £180, employed wife £110, and each child £60), the first £50 of taxable income is taxed at 15 per cent as before, the next £200 at 30 per cent instead of £75 as in 1947-48, and the remainder at the full standard rate of 45 per cent plus surtaxes ranging from 10 per cent on gross incomes over £2,000 to 52.5 per cent on those over £20,000.

(d) To encourage the return of women to industry, a new benefit was introduced permitting the employed wife as well as the husband to receive the reductions in the basis rate on the first £250 of taxable income outlined in (c).

The increase in the earned income allowance (b) will raise the ceiling on incomes qualifying for relief from £1,500 to £2,000. It was explicitly designed to relieve the tax burden of administrative, professional, and scientific workers in the middle income brackets. On the other hand, the benefits granted by raising the scale of graduation at which the reduced rates apply (c) will exempt most wage earners from the full 45 per cent rate. The total income tax relief will cost the Treasury £101 million in a full fiscal year. While this tax reduction is contrary to the anti-inflationary objective of the budget, the Chancellor anticipates that the stimulus to workers' incentives to produce will help to reduce the large deficit in Britain's external payments.

The major controversy concerning the new budget revolves about the special levy on investment income. It will apply only to taxpayers with a total income of more than £2,000 whose investment income exceeds £250. This tax, ranging progressively from 10 per cent on investment income in the £250-£500 bracket to 50 per cent on that exceeding £5,000 is in addition to the existing income taxes. As a result, incomes from this source exceeding £11,475 will be subject to rates in excess of 100 per cent. The Chancellor emphasized that this tax would be non-recurring and was designed primarily as an anti-inflationary measure. In general, the economic and monetary effects of the tax will not be great. In some cases it will be paid out of savings derived from other income sources. In others, assets will be liquidated through sales of securities to other individuals in order to pay the tax. In both circumstances, net personal savings will be reduced as the government revenue--and by the same token the government surplus--rises. To the extent that securities are sold to others, there will be a tendency for bond prices to fall and interest rates to rise. It is unlikely that the Government wishes to abandon its "cheap money" policy to such an extent, and the government departments or the banks will probably purchase sufficient amounts of securities to maintain their prices. Thus, the net absorption of purchasing power by this tax will not be large. It follows that taxes upon savings or capital will not serve as a significant brake to inflationary forces, and budgetary surpluses derived from such taxes will not necessarily stabilize the economy.

Similarly, different types of expenditure may or may not increase inflationary pressures. In the United Kingdom, a large part of the war damage payments and the excess profits tax refunds are undoubtedly saved and exert no further immediate pressure upon the economy. On the other hand, the direct purchase of goods and services by the Government may lead to an increase in prices and profits and consequently to an increase in revenues from the income taxes if the inflationary effect is allowed to propagate itself throughout other sectors of the economy. In this case, the increase in governmental income is not a check to inflation, but simply the result of other expansionary forces at work. However, the effective administration of price and rationing controls has curbed this development in the United Kingdom in the past, and it is unlikely that there will be any relaxation in such restraints upon purchasing power in the near future.

Nevertheless, neither direct controls nor moderate budget surpluses will provide a sufficient solution to the problem of inflationary pressures. The increase in liquid asset holdings in the hands of the public since 1939 approximates £9 billion, and it has been estimated that only about 50 per cent of this amount represents stable savings at present price levels. The remaining £4.5 billion seeks continuously to break through the impediments to consumer demand that the Government has erected. The pressure obviously cannot be removed within a reasonable period by higher government taxation. The incentive to produce is already adversely affected by the present high level of taxation, and any continuation of capital taxation would only reduce the propensity to save.

On the other hand, the rigid and detailed controls which must be maintained under these conditions to insure that goods destined for the export market are not voraciously consumed in the home market and that prices do not rise beyond competitive levels overseas are profoundly distasteful to the British public. The problem of removing the pent-up volume of purchasing power is one of great complexity and probably cannot be solved completely by any overall measures. It is possible, however, that insufficient consideration has been given to programs of compulsory saving and lending. Certainly, the continued illusion of abnormal internal prosperity in the United Kingdom during a period of excessive dependence upon external aid tends to retard the necessary readjustment of economic and financial policies.

CREDIT RESTRICTIONS AND DEFLATION IN ITALY

Albert O. Hirschman

October 1947 marked the high tide of Italian price inflation. After having approximately doubled within the space of a year, wholesale prices fell steadily after October and leveled off in March 1948 at 15-20 per cent below the peak reached five months earlier. The cost of living decreased by around 12 per cent. The fall in prices experienced during these months was accompanied by many familiar symptoms of depression. Industrial production fell off in spite of constant or increasing raw material and energy supplies, the stock market crashed, and important firms went through financial difficulties and often avoided bankruptcy only by subsidies from the Treasury.

The reversal of the inflationary movement in October 1947 has been most commonly associated with the quantitative credit restrictions which were issued by Minister of the Budget Einaudi in August 1947 and which became effective on October 1. As of that date all banks were to set aside an amount equal to 20 per cent of their deposits in excess of ten times their capital or an amount equal to 15 per cent of their total deposits, whichever was smaller. These amounts were either to be invested in government or government-guaranteed securities for deposit at the Bank of Italy, or to be held in an interest-bearing blocked account at the Bank of Italy or the Treasury.[1] Furthermore, 40 per cent of any net increment in deposits after October 1 was to be set aside in a similar fashion until the reserves thus created reached 25 per cent of total deposits for each bank.

It is recognized that a number of other factors have at the same time exerted a downward pressure on prices, such as the payment of the first installment of the capital levy voted in May 1947, the bumper olive crop, slaughter of livestock following the drought, and a considerable volume of franco valuta imports[2] of sugar, meat, and fats. The virtual assurance of

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1/ Previously, Italian banks were subject to the same reserve requirements to the extent of the excess of their deposits above twenty, or, since 1946, above thirty times their capital. In practice, however, this regulation which dated from 1926 was not enforced and was ineffective in view of the lag of the banks' capital accounts behind the expansion of deposits.

2/ I.e., imports financed by privately held foreign assets; see this Review, May 6, 1947.

continuity of American aid as the Interim Aid and European Recovery Programs took shape also had a significant psychological reaction.

Nevertheless, the establishment of primary and secondary reserve requirements remains among the prime causes of the October reversal because of both their real and their psychological impact. In spite of official warnings, bank credit expansion had become an increasingly important factor in the inflationary process, as is brought out clearly by the following table.

Assets of Italian Banks
(In billions of lire and per cent of total assets)

	Dec. 1944	Dec. 1945	Sept. 1946	Sept. 1947
Cash assets and reserves	140.5 42%	189.4 35%	243.9 27%	212.7 14%
Securities	88.9 27%	136.4 26%	205.8 23%	252.5 17%
Other assets	105.2 31%	209.2 39%	448.2 50%	1,045.2 69%
Total	334.6 100%	535.0 100%	897.9 100%	1,510.4 100%

Source: Bulletin of the Bank of Italy.

The "Other assets" in this table consist almost exclusively of loans to business and individuals. Some absolute and relative expansion of this category was of course to be expected with the resurgence of economic activity after liberation. The increase, however, became alarmingly rapid in the year beginning September 1946. It forced the liquidity of the banks down to a very low point and, by forcing them to withdraw reserves held with the Treasury and the Bank of Italy, created difficulties for the financing of the budget deficit. As usual, it is difficult to appraise to what extent bank loans permitted speculative hoarding of commodities at various stages of production, but in the absence of effective inventory controls there can be little doubt that a portion of the loans was so employed. In any event, the expansion of bank credit far outstripped the increase in industrial activity which from September 1946 to September 1947 increased by approximately 20 per cent.

The need for bank credit restrictions was therefore real both to contain inflation and to avoid large-scale Treasury recourse to direct advances from the Bank of Italy.

The new reserve requirements enacted by Einaudi were not calculated to bring about an actual contraction of credit on the part of the banking system as a whole: The application of the new requirements resulted in the freezing of an amount (112 billion lire) which was approximately equal to that already held by the banks with the Bank of Italy and the Treasury in cash or securities (97 and 18 billion, respectively). This freezing of a large fraction of the already scant liquid resources of the banks could not fail, however, to have a profound influence on their credit policy and on economic conditions in general. In the first place, many individual banks did not hold sufficient reserves, in cash or securities, and in their case the new requirements resulted in an actual liquidation of credit commitments. Secondly, the banks whose reserve position was adequate had considered the reserves which had been frozen as part of their available funds and immediately strove to build up excess reserves by making access to credit more difficult. Finally, a good deal of economic activity, particularly in the fields of reconstruction and investment, was predicated not merely on a constant, but on an expanding flow of credit and would therefore have been hurt even though the total volume of bank credit had remained unchanged.

The credit restrictions (in conjunction with the simultaneous payment of the first installment of the capital levy) resulted in a severe shortage of cash. Several large firms in the North experienced difficulties in meeting their payrolls. Einaudi's advice to them was to liquidate the large hoards of raw materials, foreign exchange, and extraneous assets (real estate, industrial shares, etc.) which they had acquired during the preceding inflationary phase. The fall in commodity prices, particularly in the black market, followed. The fall in foreign exchange and stock market prices which had started as early as June received new impetus. The stock markets were particularly affected as loans for purchasing or carrying securities were the first to be curtailed. Furthermore, new issues of securities which had become the only source, the Treasury apart, of fresh funds for industry were absorbed only with great difficulties by the market. The general index for variable-income securities was halved between September and February.

The psychological reactions of the credit restrictions reinforced their "physical" impact. A phenomenon that is well known from experience with rationing was noticed: Loans which were of little urgency but could not be refused by the banks were applied for even though they were not needed, thus further reducing the volume of credit for meeting real needs.1/ Furthermore, a certain distrust toward the banks developed and resulted in a reluctance to deposit and even in scattered withdrawals. Officially encouraged expectations of a continued price fall led to postponements of purchases and thereby to further downward pressures.

The stage was thus ideally set for the starting of a deflationary movement, particularly in the industries producing capital goods. To make the situation more critical, wages not only failed to decrease, but continued to increase because of their automatic but lagging connection with the cost of living. But it was precisely because the danger of an abrupt collapse of large parts of Italian industrial activity became suddenly so real that the Government started compensatory spending on a large scale: Almost immediately upon the onset of the crisis the Treasury came to the rescue of a number of threatened branches and firms, mostly in the sector of heavy industry. A 50 billion lire fund was set up for the reconversion and modernization of

1/ A black market for credit with interest rates up to 15 and 20 per cent also developed as a consequence of this situation.

the mechanical industries; the capital of the IRI (Istituto per la Ricostruzione Industriale) was increased by 8 billion lire; subsidies were granted to domestic coal, lignite, sulphur, and silk producers; special credit facilities and subsidies were given to artisans, small and medium-sized industries, as well as for the industrialization of Southern Italy.

In view of these developments, it has been observed that the Italian Government became involved in the contradiction of having its Minister of Industry undo what had been done by its Minister of the Budget. It is certainly curious to notice how Einaudi's "orthodox" policy actually led to more State intervention in, and greater State control of, Italian economic life. But aside from this point, the combination of deflation with expansionary measures in specifically selected fields was a logical economic policy for Italy to follow after the violent inflation it had undergone. Initially, the "open" postwar inflation in Italy (as in France) probably permitted reconstruction to proceed more rapidly than might have been possible under conditions of monetary stability. But as the pace of the inflation quickened, an increasing portion of the investment (hoarding of inventories and foreign exchange, non-essential building, expansion of the distributive trades) was wasteful and often competed successfully with genuine reconstruction and modernization activities. It thus became actually easier and possibly tempting to carry on these activities in a deflationary environment, i.e., in a situation where the universal scramble for raw materials, skilled labor, and foreign exchange resources would give place to a relative abundance. In Italy the temporary recession had another consequence which may prove beneficial in the long run: it exposed the profound maladjustments in Italy's industrial structure which had remained hidden as long as prices rose.

The deflationary movement might have been expected to flatten out in January/February 1948. In December, the note circulation increased by 108 billion lire or by 16 per cent as a result of heavy year-end payments combined with stationary revenue. In January, Einaudi revised the prospective budget deficit upward from the originally planned 300 billion lire to 500-600 billion, i.e., an amount similar to fiscal 1946-47. At the same time the banks had rebuilt a margin of liquidity; toward the end of January, they had accumulated 50 billion lire in excess reserves. In February, interest rates for loans to brokers and dealers collapsed from 9.50 to 1 per cent. Furthermore, the Government took a series of measures designed to revive business and investment activity: The payment of the first installment of the progressive (as distinct from the proportional) capital levy was postponed from January until June, the progressive tax on dividends was abolished and business firms were permitted to use part of their profits for the revaluation of their assets on a more realistic basis.

In spite of these developments, industrial activity continued to decline; in January it had decreased by 15 per cent from the peak reached in October even though the seasonal decline in electric power availabilities had been very slight during the winter. On the stock markets, new heavy losses were suffered in February. The reason for the continued listlessness of economic activity was, of course, the feeling of insecurity created by the approaching elections. Private investment activity came practically to a standstill and some precautionary capital flight was noticed.

In view of the outcome of the elections, there will be great need to be watchful lest an investment boom caused by the return of confidence unleash a new inflationary upsurge.

The Italian experience of the last six months--which is the closest approximation yet to the long-awaited postwar cyclical downturn--serves to illustrate a number of more or less familiar propositions:

(1) It is always possible to stop an inflation if there is a will to do so; bank credit restrictions have an important part to play in the halting of the inflationary process.

(2) It is almost impossible to arrest a violent inflationary process without provoking a deflation.

(3) While moderate inflation is compatible with, and may even assist the carrying out of, planned investment activities, such activities are likely to fare better under mildly deflationary conditions than during a violent inflationary process which results mainly in wasteful and speculative investment.

(4) Deflation is still feared more than inflation. In Italy, the latter was left to proceed for years before bringing forth energetic measures designed to combat it; while at the first sign of deflation, the alarm of public opinion was considerable and governmental action was immediately and powerfully forthcoming.

PROBLEMS IN APPRAISING THE STERLING RATE

Randall Hinshaw

The difficulties of applying statistical techniques to problems of policy are nowhere better illustrated than in the question of the appropriateness of the current dollar-sterling rate of exchange. Professor Ellis has aptly remarked that the problem of defining the equilibrium rate of exchange is vastly less difficult than the more practical problem of determining, in a concrete situation, its actual level.1/ In the present case, however, even the problem of defining the appropriate rate is beset with difficulties of a most perplexing character. At present, the British demand for foreign exchange is rigidly restrained by comprehensive import controls, while the supply is augmented by a high level of emergency financial assistance from the United States. Clearly, the exchange rate which, in these circumstances, would equate the currently forthcoming supply of foreign exchange with the demand is not the same as the rate which would equate supply with demand if imports were not controlled or if aid from abroad were not available. In the latter case, the equilibrium price of dollars in terms of pounds would almost certainly be higher, and possibly much higher, than under present conditions; and, other things equal, the British price level would also be higher. Thus we are confronted with the annoying fact that current price data--no matter how relevant the series chosen--provide no basis for price or cost parity calculations which give any indication of what the equilibrium exchange rate would be in the absence of domestic controls and external assistance, since there is no way of knowing what the British price level would be under the latter conditions. The most that can be expected from any parity calculations derived from existing data is an indication of the direction of equilibrium under the present conditions of internal control and external aid. Even for this restricted purpose, parity calculations have only the most limited reliability, and must therefore be regarded as a marginal consideration.

A serious technical difficulty in constructing parity figures which have any meaning in the present context relates to the selection of an appropriate base period. While it is of great importance that the base period should be reasonably recent, the nearest possible period that could conceivably be used as a standard of equilibrium has already been separated by almost a decade--a decade characterized by enormous structural changes in the British international position. Even if we disregard these structural changes, we are confronted with the general concensus that sterling was overvalued with respect to the dollar in the years immediately before the war.2/ The 'thirties in Britain were characterized by a persistent external deficit on current account, and in the two years preceding the outbreak of war the Bank of England and the Exchange Equalization Account suffered large losses of gold in a fruitless effort to maintain the external value of the pound. In part, the latter difficulties were the result of the disturbed international situation, but they also were a reflection of unfavorable price developments. In relation to 1929, the purchasing-power parity of the pound in 1939, as measured by cost-of-living data, was $4.10. Even this figure

1/ Howard S. Ellis, "The Equilibrium Rate of Exchange" in Explorations in Economics, McGraw-Hill Book Company, Inc., 1937, p. 27.

2/ Cf. Thomas Balogh, "Foreign Exchange and Export Trade Policy," Economic Journal, March 1940, p. 2.

may have been above the equilibrium value of the pound in the late 'thirties, as there are reasons to believe that the pound was overvalued in 1929.

The table below contains price parity calculations based on three series: (1) cost of living, (2) wholesale prices, and (3) export prices. The parities are computed in the conventional way, with 1939 as a base. However, the 1939 purchasing-power parity, as derived above, is used instead of the 1939 average exchange rate as the standard of equilibrium.1/

Purchasing-Power Parity of the Pound Sterling

Price Series Used	1939	1946	1947
Cost of living	\$4.10	\$4.48	\$5.09
Wholesale prices	4.10	3.79	4.34
Export prices	4.10	3.64	3.82

According to these computations, the pound in 1947 was undervalued on the basis of cost-of-living and wholesale-price data, and was overvalued on the basis of export-price data. Of the three series, the one based on cost-of-living figures is perhaps the least relevant. At the present time, the cost of living in Britain is maintained at an artificially low level by means of price ceilings, rationing, and subsidies. While under more normal conditions parity computations based on export-price data are open to serious objections, in the present problem they probably provide more reliable evidence of the direction of equilibrium than either of the other two series. Indeed, any evidence which may be construed as indicating that the pound should be appreciated must be regarded with suspicion. At a time when there is marked external pressure on the British reserve position--even under conditions of tight import control and extensive aid from abroad--there can be little doubt that equilibrium is in the direction of depreciation.

This does not necessarily mean that depreciation in the present circumstances would be a wise policy. It is possible that the desirable effects of depreciation can be achieved with less overall injury by other means. The latter question, however, is beyond the scope of this note.

1/ For example, the parity rates for 1947 were derived as follows: parity rate $= \$4.10 \times \frac{\text{United States price index for 1947}}{\text{Foreign price index for 1947}}$. All price indexes were first converted to a 1939 base.

NEW FOREIGN TRADE POLICY FOR BIZONAL GERMANY — J. Herbert Furth

The low level of the foreign trade of bizonal Germany[1] frequently has been attributed to the lack of a fixed relation between the reichsmark and foreign currencies. The military rate of 10 reichsmarks per dollar--which grossly undervalues the reichsmark on the basis of German legal domestic prices--was not used in foreign trade. Instead, commercial imports and exports were priced by the Joint Export-Import Agency of the U.S.-U.K. zones (JEIA) in two different ways: in terms of dollars at world market prices, as far as the foreign exporter or importer was concerned, and in terms of reichsmarks at the German legal ceiling prices, as far as the German importer or exporter was concerned. In other words: foreigners paid to JEIA dollars at world market prices for German imports; but the German seller received from, and the German purchaser paid to, JEIA reichsmarks at the German domestic legal ceiling price. In this manner, world market prices and German domestic prices remained completely unrelated to each other. For some commodities, the German prices compared to world market prices at a ratio of approximately 30 U.S. cents per reichsmark; generally the ratio was much higher, in a few cases reaching almost 100 cents per reichsmark. Since the German producer in all cases received only the German legal ceiling price in reichsmarks, it did not make any difference to him whether the world market price of his product was high or low. In consequence, there was no inducement for German producers to concentrate upon exports, and especially upon the exports of those goods that were in greatest demand abroad and would have brought the highest prices in terms of dollars.

In order to encourage production for export of such goods, and at the same time to prepare for a readjustment of the German domestic price system to world market levels, the Bipartite Board--the supreme authority of the occupying powers in the economic affairs of the U.S.-U.K. zones of occupation--instructed the Bizonal Economic Council on March 24, 1948, to put into effect the following new policy for pricing commercial imports and exports:

(1) Imports will be priced in reichsmarks at contract cost in foreign currencies converted into reichsmarks at the rate of 30 U.S. cents per reichsmark.

(2) Exports--except for exports of coal--will be priced in reichsmarks at the contract selling price in foreign currencies converted at the rate of 30 cents per reichsmark. If the reichsmark proceeds so calculated are less than the present legal reichsmark price, the exporter will continue to receive the present price.

(3) Producers of ceramics and textiles can dispose of 40 per cent of their export proceeds in foreign currencies for the importation of equipment and materials and other necessary foreign payments.

The reichsmark price of commercial imports in most cases will be higher at the new rate than under present regulations. This will necessitate higher prices for goods into which the imported commodities (mainly raw

1/ See this Review, March 23, 1948, p. 1.

materials) are incorporated. Commercial imports, however, will remain at a relatively modest level even under the latest ERP proposals: about half of total imports (foodstuffs, fertilizer, and petroleum products) will continue to be financed by the occupying powers and will not be affected by the new price rules. The impact of these price changes on the domestic economy therefore will not be very considerable.

The reichsmark price of export goods also will increase in most cases, but the price will remain considerably lower than black market quotations. As long as the opportunity for black market transactions is not substantially curtailed, the fact that export prices will be somewhat higher than legal domestic prices will hardly constitute a very effective incentive for German producers to sell their goods abroad. Furthermore, any diversion of German goods from domestic to foreign markets will benefit the German economy only as far as export proceeds are used for increased imports without undue lags.

The allocation of export proceeds to textile and ceramics manufacturers is an extension of a general, but more modest, scheme adopted in the summer of 1947.1/ The scheme has had scant success so far. Efforts of producers to use their foreign exchange quotas for additional imports have been hampered by supply difficulties, and it is reported that some producers made only half-hearted efforts to overcome those obstacles and were quite satisfied with holding foreign exchange balances rather than reichsmarks pending a decision on currency reform. The use of those foreign exchange holdings will have to be stringently controlled in order to prevent the owners from hoarding them or from using them for the importation of goods not vitally needed by the German economy.

The new directive thus will be significant primarily as a symptom of a new policy rather than because of its immediate practical consequences. This new policy not only means a return to greater freedom in bizonal international trade, but also perhaps foreshadows the setting of a new general exchange rate for the reichsmark. The 30 cent rate already has been used for a number of purposes (payment of dollar earnings to released prisoners of war; conversion of international communication and transportation charges), and the military 10 cent rate has retained little practical significance. The 30 cent rate might be formally adopted as a general rate of exchange as soon as the proposed currency reform finally is put into effect. Meanwhile the occupation authorities in the combined zones have decided not to maintain any longer the rigid price-stop initiated by the Nazi regime and taken over by quadripartite agreement. The new Bizonal Economic Administration is to be entrusted with the task of raising domestic prices that have become untenable because of changes in wages and other cost factors. If the Administration manages to perform that function in such a way as to abolish some of the most flagrant discrepancies between the patterns of German and world market prices in internationally traded goods without reinforcing inflationary pressures, the introduction of a general exchange rate will be greatly facilitated.

Price, exchange rate, and currency reform regulations in themselves cannot solve the problems of the German economy. Rehabilitation will have to be accomplished by a radical improvement in the efficiency of German labor and management. Monetary measures, however, can remove obstacles to, and provide some incentives for, the development and utilization of the productive forces of the German people.

1/ See this *Review*, August 26, 1947, p. 11.