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Financial Problems of Western Germany
By J. Herbert Furth . . . . 7 pages

A Note on the "Secondary Burden" Involved in Correcting Balance of Payments Disequilibria
By Gerald Alter . . . . 3 pages

Export Prices and Western European Exchange Rates
By Randall Hinshaw . . . . 2 pages

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FINANCIAL PROBLEMS OF WESTERN GERMANY J. Herbert Furth 1/

The success of the German currency reform 2/ has eliminated to a considerable extent most of the financial obstacles which have hampered economic progress in Western Germany since the end of the war. However, a number of serious questions still remain unsolved.

The Threat of Stagnation. The post-reform trend toward an inflationary expansion of currency and credit, which was accompanied by a substantial rise in prices, has disappeared since the beginning of 1949. However, the sharp rise in production now appears also to have come to an end. The bizonal index of industrial production, which had risen from 51 to 79 between June and December 1948, continued to climb until it reached 90 in March 1949, but then receded slightly to 85 in June 1949. Between June 1948 and June 1949, bizonal unemployment increased from 442,000 to 1,238,000, or from 3.5 per cent to 8.5 per cent of the industrial labor force. The number of persons employed has remained virtually unchanged with the consequence that the additions to the labor force were not absorbed into the process of production.

Opinion in Germany is sharply divided as to the significance of these developments. One school of thought maintains that they represent a healthy readjustment necessary to overcome abnormal conditions of the recent period of repressed inflation. According to this school, many uneconomical enterprises, founded under conditions of inflation, must disappear again; the labor force must be directed from the areas of labor surplus to those of labor deficit; and the productivity of labor must be restored at least to prewar levels in order to make German industry again competitive in the world market. This school therefore objects to any attempt at government interference with that process.

The other school points out that the existence of a relatively heavy unemployment in a country, which is in dire need of more labor for the work of rehabilitation, is in itself a symptom of economic disorganization and calls for remedial action. This school emphasizes the social and political consequences of unemployment, and asserts that both the lull in economic progress and the rise in unemployment could easily be fought by making long-term credit available to the various industries which now have to restrict their activities because of the lack of available funds. This group, therefore, regards the development of the last six months mainly as a result of an over-cautious credit policy of the government and the central banking system.

Interestingly enough, the conflict between these two schools is not one between right- and left-wing economists or politicians. In Frankfurt, the seat of the bizonal administration, the conservative viewpoint is shared by persons of strictly socialist persuasion, while in the industrial area

1/ The author has just returned from a trip through Central Europe.
2/ See this Review, March 8 and March 29, 1949.

of North-Rhine Westphalia even the banking community tends to adhere to the more "radical" opinion.

Actually, the process seems to be a combination of an inevitable readjustment and of the results of restrictionist central banking policy. It is true that an indiscriminate increase in the means of payment in circulation probably would not only retard the process of adjustment but also bring about a renewed danger of inflationary developments. However, a cautious policy of making some investment funds available to enterprises with reasonable plans of reconstruction and development would probably raise production and diminish unemployment without hampering the equilibrating tendencies within the economic system. Although the "conservatives" are right in asserting that in the final analysis the funds needed for investment must be created by voluntary savings rather than credit creation, there seems to be little danger of inflation if newly created credits merely anticipate future savings and shorten the lag between savings and investment.

The Scarcity of Capital. The problem of economic progress is complicated by the abnormal character of savings and investment in the present Western German economy.

As an inevitable aftermath of hyper-inflation, voluntary private savings have been greatly reduced. In the first half of 1949, savings deposits increased by a mere 250 million marks ($75 million), and this saving was largely deferred consumption, i.e., the putting away of parts of income for the purpose of purchasing homes or other durable goods as soon as the necessary amount for the down payment would be reached. As a consequence, the savers are not willing to invest their savings in long-term securities, and the capital market is virtually non-existent. High-grade bonds can be purchased on the stock exchange at a price yielding a return of 7.5 per cent or more; it would be uneconomical to issue new bonds carrying such an interest rate. Under these conditions it is easy to understand why a recent attempt to float a bond issue of the federal railways ended in complete failure.

The only type of substantial private saving and investment now takes the form of "plowing back" proceeds of enterprises. This process has been reinforced by two consequences of the currency reform, namely, the windfall profits which accrued to most enterprises in connection with the rise in prices during the second half of 1948, and the continuing high rate of taxation. Even without windfall profits, the spread between prices and wage rates assures most enterprises very high profit margins, and the bulk of these profits is being used to replenish depleted capital. Profits used for repairs or investments are to a large degree exempt from taxation; this exemption is especially important in view of the fact that even moderate incomes are hit by income tax rates of 80 per cent or more.

It is estimated that in the period from June 1948 to June 1949 this program of self-financing of investments amounted to more than 8 billion

German marks ($2.4 billion) or substantially more than the total net investment program for that period submitted to OEEC. This procedure certainly facilitated the rehabilitation of Western German industry, but it also resulted in some serious mis-investment. Frequently the most profitable enterprises were those that needed the least amount of reconstruction or additional investment, e.g., wholesale traders. Moreover, many investments took the form of semi-luxury expenditures (elaborate office furniture, store facades, etc.) rather than of productive equipment.

The only other important source of savings and investment was the accumulation of a sizeable surplus by public authorities, including "counterpart funds" resulting from GARIOA and ECA imports and a surplus of current revenue over current expenditures of the German Laender. While large parts of the GARIOA counterpart funds were spent in connection with occupation expenses, mainly the Berlin airlift, no ECA counterpart funds were released at all before August 1949. Altogether, the deposits of public authorities with commercial banks increased by 1.5 billion marks between July 1948 and April 1949.

The accumulation of counterpart funds can easily be remedied by hastening releases for purposes consistent with the ERP. The program can be carried out rapidly through the Reconstruction Loan Corporation, a German public institution which grants long-term credits to municipalities and private industry.

It is more difficult to allocate economically the funds of the Laender. The decentralization of public finance in Western Germany has resulted in serious inequality of the various Laender: those that need public expenditures most urgently are often too poor to accumulate a surplus, and those that have the largest surplus also have the largest amount of private savings at their disposition. Since the currency reform law forbids the Land governments to incur a deficit, this inequality cannot be remedied by allowing the poor Laender to borrow from the wealthy one. Attempts to redistribute part of the surplus from the more wealthy to the poorer Laender by legislation have had very limited success. Moreover, the prevalence of public capital in an economy trying to rely more heavily on private initiative presents many contradictory features. However, a reduction in the tax burden with the view to reducing the surplus of the wealthier Laender so as to channel capital from public to private hands is considered dangerous by many experts since reduced taxation may well increase consumption rather than savings.

The Role of Banking Organization. The scarcity of capital is aggravated by the overcautious policy of the central banking system and the financial weakness of the commercial banks and private bankers.

The central banking system, consisting of the Bank Deutscher Laender and its affiliated Land Central Banks, is in a relatively strong position. On June 30, 1949, it held foreign exchange (formally as trustee for the occupation powers, but actually for the requirements of the Western German economy) to a net amount of $390 million; these assets, plus claims arising from bills of exchange and other commercial transactions, cover 30 per cent of its note circulation and demand deposits -- a far cry from the days when virtually all assets of the German central banking system consisted of claims against the Government. However, the system has steadfastly refused to provide means for long-term credit to the economy.

All other financial institutions suffer from an acute shortage of capital. Because of that shortage, the Reconstruction Loan Corporation has not yet been able to play a significant role in the lending field. Originally, it was supposed to receive all of the deposits "temporarily blocked" under the currency reform act, amounting to more than 600 million marks. Actually, however, the use of these blocked deposits for purchasing bonds of the Corporation has been left to the decision of the holders; now it is feared that without granting these bonds extensive tax privileges, it will be difficult to channel any private funds to the Corporation. By the end of May 1949, the Corporation had received only 245 million marks, mainly out of GARIOA counterpart, and had granted loans of only 113 million. The only other institutions in the long-term credit field are the mortage banks which are suffering from an equally severe shortage of funds.

The commercial banks have been hard hit by the currency reform which reduced their capital to 5 per cent of their total deposits. Moreover, the expansion of credit since the currency reform has about doubled bank deposits so that the ratio of capital to deposits has dropped to about 2.5 per cent. Risk assets (discounts and advances to others than public authorities) have risen even faster than deposits and the ratio of capital to risk assets probably is not higher than 3 per cent. This margin is too low to permit any but the safest credit transactions.

Under the Allied decentralization policy, no bank is permitted to have branches outside of the Land where its headquarters are located, and the "big three" banks have been split up into 30 new institutions. This development is hailed by progressive members of the banking community as a first step toward restoring competition in banking and ending the rule of the big banks over a considerable part of German economic life. Others feel, however, that in the process of reconstruction and development the new institutions will remain too weak to fulfill the functions of a sound banking system.

Despite decentralization, the banks have maintained close relations with each other and have even managed to continue their prewar "cartel", fixing interest rates and other terms of business. With the help of that "cartel", the banks maintain a margin of 3 per cent between the rediscount rate of the Central Banks (4 per cent since July 14, 1949) and their own discount rates, thus making credit to customers quite expensive. The Allied authorities have tried to force the banks to abandon their collusive practices, but so far have had little or no success in their endeavors.

Private bankers are the weakest link in the banking structure. Their capital has also been reduced to 5 per cent of their deposits, exactly like that of the commercial banks. However, since the ratio of capital to deposits had been customarily far higher in the case of the private bankers, this reduction hit them far worse than it did the commercial banks. Their supplications for relief have not yet led to a satisfactory solution, largely because the bankers have rejected an offer of help from the Reconstruction Loan Corporation for fear that such help might lead to the domination of private banking by that agency.

The reluctance of commercial banks and bankers to take risks, which is the natural result of their impaired capital position, may contribute to the present recession. The credit situation is particularly bad in Hamburg, where private banking used to play an important role in the financing of foreign trade; especially so since the large export and import merchants themselves have suffered great losses and are at present unable to finance a substantial margin of their operations without banking aid.

The Balance of International Trade. Despite the stagnation in domestic business, commercial imports and exports continue to grow.

The increase in imports is due to the relaxation of import restrictions formerly imposed by the Allied authorities; in June 1949, the foreign exchange reserves of Western Germany declined for the first time, indicating that commercial imports had exceeded exports. By the middle of 1949, commercial imports were estimated at an annual rate of $1.3 billion, while GARIOA and ECA imports probably amounted to a total of about $0.9 billion annually. The combined amount was only about 25 per cent below the sum of $2.8 billion annually, which is widely supposed to be necessary for making possible the working of the Western German economy at satisfactory levels of consumption and production.

At the same time, exports were approaching an annual rate of $1.4 billion, or about 50 per cent below the amount necessary to finance the "normal" level of imports. It was particularly gratifying that exports of finished goods increased to 60 per cent of the total, as compared to 40 per cent in 1948 and 50 per cent in the average of the first half of 1949.

The main problem of Western Germany's international trade continues to be the geographic distribution of its imports and exports. Western Germany sells 85 per cent of its exports to other OEEC nations. On the other hand, it is able to purchase about half of its imports from the United States because of relatively large GARIOA and ECA dollar allocations. As a result, the other European nations are unable to sell to Western Germany many goods for which they had been accustomed to rely upon the German market, and to equilibrate their balance of trade with that area. They reproach therefore the United States for making "too many dollars" available to Western Germany and at the same time reproach the Allied authorities in Western Germany for insisting "too strictly" upon the principle of buying in the cheapest market. On the other hand, the Allied authorities could hardly justify buying goods at greater expense in other European countries as long as they are available more cheaply in the United States. The conflict of opinion is at present being softened by the establishment of "drawing rights" under ERP, which make it possible for Western Germany to have an export surplus with the other European countries without draining them of dollar reserves. As soon as this help ceases, the problem will become very serious. An obvious solution would be a change in the exchange relation between the other European currencies and the dollar -- whereby the mark could remain tied to the dollar or be tied to the pound sterling --; such a change would automatically make European products relatively less expensive than American products in terms of marks, and thereby correct the flow of imports into Western Germany; it must be remembered that in 1937, for instance, German imports from the United States amounted to only $114 million, as compared with an annual rate of $908 million in the first half of 1949.

Another complaint of the other European nations is levied against the cost advantage now enjoyed by German industry because of the low level of wages. In a paradoxical way, the neighbors of Germany feel concerned about the apparent willingness of the German worker to accept for the time being a very low standard of living, in order to enable German industry to regain its position in the world market. The other European nations fear in particular that, under a system of free trade, they would soon have to face the unbeatable competition of the reconstructed Ruhr in the field of heavy industry.

The standard of living and the wage level of the Western German worker may be expected to rise, but that rise may easily be balanced by an increase in the productivy of labor. Moreover, Western German heavy industry will continue to enjoy its comparative advantage based on the excellence of the Ruhr coal mines and the skill of German management and labor. This advantage cannot be counteracted by exchange rate adjustments. The newly-constituted Ruhr authority and the Military Security Board will provide relief only insofar as the revival of German heavy industry threatens to have political and strategic implications. Purely economic discrimination against Western Germany would be irreconcilable with U. S. economic policy as a matter of principle.

It is true that under a system of free trade, the other European nations might gain more by increased exports of consumers' goods to Germany than they would lose from the German competition in the field of producers' goods. However, advocates of a free economy form only a tiny minority of European economic theorists and practitioners, and it seems likely that the future of Western German foreign trade will not be decided on the basis of free competition. Both German and non-German industrial leaders openly express their hope that the "harmonization and integration" of the European economy will be accomplished by means of "commodity agreements", strongly reminiscent of the prewar international cartels, and that OEEC will become the nucleus of such a system.

So far, no official proposals have been made to transform OEEC into an inter-European super-cartel. Western Europeans probably fear that such proposals might endanger the continuation of ECA assistance, because of American antipathy to cartels; they may also hope for the U. S. Senate to reject the Havana Charter, the adoption of which would make the formation of international cartels more difficult and their operation less restrictive. Finally, they probably wish to make sure that the organization would not be dominated by Germany, the greatest industrial nation in continental Europe. The stronger the impact of Western German reconstruction, however, the greater will be the inclination of Western Europeans to substitute restrictive "agreements" for competitive struggle. This danger can be averted only if the United States continues to attack all manifestations of economic nationalism, and to support -- and implement -- the principles of freedom and expansion of world trade.

CONFIDENTIAL

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A NOTE ON THE "SECONDARY BURDEN" INVOLVED IN CORRECTING BALANCE OF PAYMENTS DISEQUILIBRIA

Gerald M. Alter

In the current discussion of exchange rate adjustments, it has been argued that one of the unfavorable effects of exchange depreciation as a means of correcting a balance-of-payments disequilibrium is a deterioration in the terms of trade. Such a deterioration in the terms of trade following upon exchange devaluation results in magnifying the reduction in consumption and domestic investment which develops through the elimination or reduction of an import surplus, and this has been called a "secondary burden".

It is now generally recognized that exchange depreciation need not necessarily involve a deterioration in the terms of trade. For example, in a country whose imports and exports constitute a negligible portion of world trade, an increase in the volume of its exports and a reduction in the volume of its imports is unlikely to affect prices (as quoted in foreign currency). However, a relatively small country whose exports are concentrated in commodities such that it occupies an important role in the world market depreciation, to the extent that it increases exports, is likely to lead to a decline in export prices. Such a country's imports, however, are likely to be more diversified, and a reduction in the volume of imports is, therefore, less likely to reduce prices of imported goods. As a result, the terms of trade are likely to become unfavorable. Another country (or group of countries jointly considering devaluation) might occupy a very important role in world markets, both as an exporter and an importer, and in this case it is probable that depreciation, when effective in reducing imports and increasing exports, will reduce both export and import prices. The terms of trade may deteriorate in this case, but this cannot be determined on the basis of any general argument.

Although it is generally understood that exchange depreciation may or may not lead to a deterioration in the terms of trade, it is by no means generally recognized that <u>if</u> exchange adjustments turn the terms of trade against the country whose exchange rate is devalued, the deterioration in the terms of trade is not the unique result of devaluation itself. Other measures taken to reduce an import surplus by increasing exports and reducing imports would have similar effects. It is the combined effect of shifts in the countries' demand schedules for imports and supply schedule of exports, these schedules being formulated in terms of foreign prices of commodities traded, which precipitates the change in the terms of trade. The Government, by direct controls, might force the manufacturers to set aside a larger proportion of their output for sale in export markets. In the case of devaluation, the exporters would presumably do this on their own initiative because export sales would become more profitable. However, regardless of whether the shift in the supply schedule of exports is induced by devaluation or by direct allocation, the price of export commodities in foreign markets will decline if the profits of the manufacturers are maximized in one case and the orders of the Government are made effective in the other case. 1/

Similarly, on the side of imports a given volume reduction, whether induced by exchange devaluation or by direct import (or exchange) controls, will have the same effect on import prices. It is the shift in the demand schedule for imports which brings about a reduction in foreign import prices and not exchange depreciation as such.

Where exchange devaluation would lead to a deterioration in the terms of trade, it can be assumed that resort to direct controls operating on both exports and imports would have similar results. It should be recognized, however, that balance-of-payments correctives need not apply indiscriminately to both exports and imports. A country may attempt to eliminate an import surplus by a restriction of imports without encouraging exports, through either devaluation of exchange rates applicable only to imports or through direct control of imports. If it chooses to rely only on reducing imports, a country (or group of countries) with a deficit in its balance of payments and one which occupies a very important role as a purchaser in world markets might substantially improve its terms of trade.

It would, however, be erroneous to conclude that balance-of-payments correctives which lead to an improved terms of trade--or the minimum deterioration--are necessarily the most beneficial. The fact that imports might be purchased at a lower price if measures are taken to reduce their volume is by no means a definitive test of the desirability of doing so. Similarly, the fact that exports may have to be sold at a lower price is not a conclusive argument against expanding exports. The home market might decide to sacrifice to foreign markets an additional volume of goods which are domestically produced, while retaining a higher volume of imports than would otherwise be possible, even if this involves less of an improvement--or more of a deterioration--in the terms of trade.

This is, of course, one of the standard arguments cited in favor of permitting changes in unitary exchange rates to make necessary balance-of-payments adjustments. The "equilibrium" exchange rate secures a pattern of trade and volume of exports and imports which reflects, among other things, the relative priorities placed by the market on the various commodities produced at home and abroad, the substitution relationships and relative costs prevailing in the production of these commodities. It is argued that, if a deficit in the balance of payments is to be corrected, devaluation of the exchange rate to an equilibrium level can secure a balanced adjustment as between reducing imports and increasing exports.

1/Under some circumstances larger export quotas may be insufficient actually to induce exporters to sell more abroad, that is, it might be necessary to fix production schedules as well, or/and grant export subsidies.

Many Governments today are reluctant--often for what appears to us as a good reason--to rely exclusively upon the dictates of a free price mechanism, in which the exchange rate is included, to determine the allocation of resources and the volume of imports and exports. However, some of the arguments cited against reliance on exchange rate changes are spurious. One such argument is that exchange depreciation, in contrast presumably to other methods of adjusting balance-of-payments deficits, leads to a deterioration in the terms of trade. It has been shown that exchange depreciation, when it operates in this way, is not unique. Furthermore, the argument implies that as between different methods the one which leads to the minimum deterioration in the terms of trade is necessarily to be preferred. In placing such emphasis on the implications for the terms of trade, the argument ignores important elements of social cost involved in the allocation of resources as between production for export and for domestic use. The relevancy of such costs certainly cannot be denied, particularly by those who deny the adequacy of the market mechanism properly to reflect them.

CONFIDENTIAL

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EXPORT PRICES AND WESTERN EUROPEAN EXCHANGE RATES

Randall Hinshaw

Under present conditions of currency inconvertibility, prices of like goods can differ from one area to another by a much wider margin than would be expected on the basis of transportation costs and customs duties. Consequently, export prices, which, under normal conditions of international price integration, would be of little assistance in evaluating exchange rates, are in the present circumstances of foremost relevance. By relating relative changes in national export price levels to a pre-war norm, it should be possible to obtain a rough indication of the degree to which foreign currencies are overvalued or undervalued with respect to the dollar. In the last issue of the Review of Foreign Developments,1/ this procedure was applied to the pound sterling, which, on the basis of the official British and United States export price indexes, was found to be substantially overvalued. In the present note, the same method has been applied to a number of other Western European currencies.

In the following table, "export-price parities" are computed for the currencies of Belgium, Denmark, France, Norway, Sweden, and Switzerland. These parities are derived by the same method used in the calculation of conventional purchasing-power parities, with the exception that export price indexes are substituted for domestic price series. It can be seen from the table that, on the basis of either the 1937 or the 1938 average exchange rates, all six currencies appear to be currently over-priced in terms of the dollar. On a 1937-38 base (Column D), the estimated degree of overvaluation (Column E) ranges from about 15 per cent in the case of the Swedish krona and the Belgian franc to 39 per cent in the case of the Danish krone.

These figures, which must be regarded as subject to a considerable margin of error, support the widely held view that the Belgian franc is among the least overvalued of Western European currencies. Lack of data made it impossible to confirm by the foregoing method the similar opinion concerning the Italian lira. The currencies of France, Norway, and Switzerland appear to lie within an intermediate range of overvaluation (24 to 31 per cent), a range which would also appear to include the pound sterling.2/

1/ Randall Hinshaw, "Export Prices and the Dollar-Sterling Rate," Review of Foreign Developments, No. 118, August 2, 1949.
2/ Ibid.

Export-Price Parities of Western European Currencies
(In cents per unit of foreign currency)

	A	B	C	D	E (A as % of D)
		Export-Price Parities c/			
Country	Present Exchange Rate a/	On basis of 1937 average exchange rate	On basis of 1938 average exchange rate	Average of B & C	Index of Over- or Under-valuation (100=par)
Belgium	2.275	1.893	2.041	1.967	115.6
Denmark	20.854	14.455	15.539	14.997	139.0
France	0.385 b/	0.324	0.296	0.310	124.2
Norway	20.158	15.574	16.582	16.078	125.4
Sweden	27.823	25.079	23.232	24.156	115.2
Switzerland	23.363	n.a.	17.794	17.794	131.3

a/ August 15, 1949.
b/ Average of official and free rates.
c/ Calculations are made on the basis of the June 1949 export-price figure for the United States and the latest available foreign figure. For Denmark and Switzerland, the June figure is used; for Norway, the May figure; for France, the March figure; and for Belgium, the fourth quarter of 1948. All foreign series are taken from the Fund publication, International Financial Statistics.