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REVIEW OF FOREIGN DEVELOPMENTS

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August 30, 1949

U. S. BALANCE OF PAYMENTS PROSPECTS, 1949-50 1/

Florence Jaffy

United States exports in 1949 may be expected to fall noticeably from the 1948 level, due largely to the decline of U. S. purchases from abroad, and to the probable failure of U. S. Government foreign assistance to rise enough to compensate. For the fiscal year 1949-50, it is expected that a still sharper drop will occur as a result of the application of new trade restrictions by the members of the British Commonwealth. In both periods reduction in liquidation of foreign gold and dollar assets and declines in private lending may also be expected.

The estimates on which these conclusions are based assume that Congress will appropriate funds for the ECA as recommended by the Senate. Due to the controversy over the Military Assistance Bill, the estimates do not make provision for arms shipments to foreign countries; if, however, that bill were passed, an amount between $.4 and $.5 billion might be added to recorded exports for fiscal 1949-50. It is believed that transfers within the next year by private investors will not differ significantly from the estimates, whether or not Congress authorizes the Export-Import Bank to extend guaranties on private investments.

All estimates are based on the existing structure of exchange rates. The following summary table shows actual figures for calendar 1948 and estimated figures for calendar 1949 and fiscal 1949-50.

Summary Table*

Sources of Financing of U. S. Exports, 1948-1950
(In billions of dollars)

	Calendar 1948 (Actual)	Calendar 1949 (Estimated)	Fiscal 1949-50 (Estimated)
Payments for U.S. imports of goods and services	10.5	9.7	8.9
U.S. Government aid and loans	4.7	6.2	5.5
U.S. private aid and loans	1.7	1.1	.9
Lending by International Bank and Fund	.4	.1	.2
Net liquidation of gold and dollar assets	.9	.5	.2
Total financing	18.0	17.6	15.7
Adjustment for errors and omissions	-1.2	-1.4	-1.0
U.S. exports of goods and services	16.8	16.1	14.6
Current account surplus	6.3	6.4	5.8

* Figures may not add to totals because of rounding.

It will be noted that the projected decline in imports of goods and services for calendar 1949, compared to calendar 1948, exceeds the decline in goods and services exports, so that a slight increase in the current account surplus from

1/ Estimates prepared with the assistance of the Department of Commerce, International Economics Division. All balance of payments data for 1948 are derived from this source.

$6.3 to $6.4 billion appears. This slight increase for the year as a whole, however, conceals a decline in the current account surplus from an annual rate of $6.6 billion in the first half to an annual rate of $6.2 billion in the second half of 1949 (for details see Table I). Moreover, in fiscal 1949-50, due to prospective reductions in dollar availabilities other than earnings from exports to the United States, the current account surplus may fall still further, or to a figure of $5.8 billion.

The deduction for errors and omissions is one which has proved necessary in substantial amounts over the past few years. While every balance of payment calculation necessarily contains some "errors and omissions", these might under ordinary circumstances be expected approximately to cancel out. The existance of a large discrepancy on the credit side for the past several years probably indicates the existence of a large amount of unrecorded capital movement to the United States. The total discrepancy amounted in 1948 to $1.2 billion and may reach close to one billion in the first half of 1949. While the projection of such a figure is, of course, a highly uncertain matter, the results of omitting it entirely from the estimates would be clearly misleading. Hence, figures of $1.4 billion for calendar 1949 and $1.0 billion for fiscal 1949-50 have been included in the estimates.

The detailed breakdown of the estimates discussed below is shown in Table I:

1. Imports of goods and services

Although recorded imports in the first quarter of 1949 were only slightly below the 1948 level, the drop was accelerated in the second quarter. They may be expected to decline still further during the rest of the year and in the first half of 1950, due to (1) the decline in economic activity in the United States and (2) the recent decline in import prices, which has not led to a compensating increase in the volume of trade. The estimates used here for imports of goods and services ($9.7 billion in 1949 and $8.9 billion in fiscal 1949-50) represent a decline of 8 per cent for calendar 1949 and of 15 per cent for fiscal 1949-50, as compared to 1948.

2. U. S. Government aid and loans

The sharp increase anticipated in U. S. Government grants for 1949 ($5.5 billion compared to $3.8 billion in 1948) is due to the fact that it was not until the beginning of this year that the operations of the European Recovery Program reached their full stride. In all of 1948 the ECA financed shipments of only $1.9 billion (of which $1.4 billion were on a grant basis), whereas in the first half of 1949 it financed shipments of about $2.4 billion (of which about $1.9 billion are on a grant basis).

The estimates of $4.5 billion used here for total ERP assistance (for both grants and loans) in calendar 1949 and of $3.9 billion in fiscal 1949-50 assume a deficiency appropriation of $1.0 billion for fiscal 1949 and the appropriation or authorization of $3.8 billion ERP funds for fiscal 1950. It takes also into account a backlog of unexpended funds (for both grant and loan purposes), which as of June 30, 1949 amounted to about $1.8 billion, and assumes that funds will be expended at such a rate that the size of this backlog will be reduced slightly by June 1950. This calls for a gradual tapering off of the rate of expenditure of ECA funds, which reached a rate of $465 million per month in June of this year. The loan portion of the total expenditure was estimated by assuming a total loan expenditure of about $.5 billion in 1949 (a little under $1 billion for fiscal 1949,) and of $.1 billion for fiscal 1950. 1/ It is expected, therefore, that ECA operations will raise the 1949 and fiscal 1950 totals of U. S. foreign aid to the highest figure since 1945, when lend-lease transfers were responsible for large amounts. However, it is assumed that the year 1949 will also represent the peak period for European assistance, and that it will slowly decline thereafter.

Actual monthly rates of expenditure of ECA funds and rates of issuance of procurement authorization, together with funds available to date, are shown in Table II. It will be noted that the rate of issuance of procurement authorization, while very uneven, tends to earmark all the funds available to ECA. There is, however, a considerable lag between the issuance of procurement authorizations and the actual disbursement of funds.

It is assumed that the $1.0 billion appropriation requested by the Department of the Army for civilian supplies for occupied areas will be cut slightly. Since the request itself represented a reduction of about $300 million under last year's request, expenditures in 1949 and fiscal 1949-50 will probably fall below those for 1948.

Other U. S. Government assistance in the form of grants includes the Korean aid program (for which the President has requested an appropriation of $150 million for the fiscal year 1949-50), additional aid to Greece and Turkey (for which $50 million in new appropriations has been asked), and the continuation of other programs, such as Philippine War Damage and Rehabilitation, the International Refugee Organization, etc.

Loans from U. S. Government agencies have been estimated at $.7 billion for 1949 and $.3 billion for 1949-50. The reduction from 1948 figures is due largely to the exhaustion of the British loan in 1948 and the reduction in expected Export-Import Bank disbursements. The ECA loan estimates of $.5 billion for 1949 and $.1 billion for 1949-50, have been discussed above. The Export-Import Bank estimates of gross disbursements of $.2 billion in 1949 and $.3 billion in 1949-50 do not include the relatively small amounts disbursed by private banks under guarantee by the Export-Import Bank. The reduction in Export-Import Bank activity in the last few years 2/ is in large part due to the tapering off of reconstruction loans, as other institutions (such as the ECA and the International Bank) have been created to meet current reconstruction and development needs. As of May 31, 1949, the Export-Import Bank had outstanding loans amounting to $2,159 million. Its undisbursed commitments at that time were $397 million, and its uncommitted lending authority amounted to $944 million.

The residual figure of "Other loans and receipts" includes surplus property credits and net short-term Government advances, as well as repayments on long-term lending largely on account of Export-Import Bank loans.

1/ The Senate recommended $150 million for this purpose in fiscal 1950.
2/ Gross disbursements were $945 million in 1946, $796 million in 1947, and $454 million in 1948.

3. U. S. private aid, loans and investments

Total long and short-term private lending is estimated here at $1.1 billion for 1949 and at $.9 billion for fiscal 1950.

Private long-term investments were swelled in 1948 by the high level of new, direct investments in the petroleum industry, and by non-recurring items such as a private loan to Canada. A decline may, therefore, be expected in 1949 and the first half of 1950. Even if Congress authorizes the Export-Import Bank to undertake a guarantee program for private investments, it can be anticipated that the effects of such a program would not develop immediately and probably not before the middle of 1950. This delay may be attributed not only to the fact that the Export-Import Bank would proceed slowly at first and on an experimental basis, but also because new investment plans would take time to complete and the actual outflow of capital would occur still later.

Short-term advances by U.S. private banks in the periods considered are expected to be more than offset by repayments.

Private remittances abroad may be expected to decline somewhat from the level reached in 1948.

4. Lending by International Institutions

The policy of the International Monetary Fund during the ERP period is to conserve its resources by restricting dollar drawings by OEEC members to "exceptional and unforeseen cases" and by restricting dollar drawings by others to cases of temporary balance of payments deficit not involving fundamental disequilibrium. It may therefore be expected that dollar drawings will decline over the period being considered, from the $196 million figure in 1948 to little over $50 million in 1949 and possibly less than $50 million in fiscal 1949-50. It should be noted that almost half of the dollar drawings in 1948 occurred prior to the initiation of the European Recovery Program in April 1948.

The International Bank, which disbursed $176 million in 1948, disbursed only $18 million (net) in the first half of 1949. However, it has recently announced the conclusion of loan agreements with the Netherlands, in the amount of $15 million, Finland, in the amount of $12.5 million, Colombia, in the amount of $5 million and India, in the amount of $34 million. The Bank has been expanding its activities recently in the direction of assisting member countries to develop investment projects suitable for financing. Loan negotiations are proceeding at present with Belgium, Turkey, British colonies, Uruguay, and the Philippines, as well as with a number of European countries in connection with a timber equipment project. At the end of June 1949 the Bank had undisbursed commitments of $123.8 million (not including the new loans mentioned above) and dollar assets of approximately $500 million. In view of its expanded plans for assistance to members and of the possible flotation of another bond issue in the American market sometime in the coming year, disbursements may be estimated at almost $100 million in 1949 and at somewhat more than $100 million for fiscal 1949-50.

5. Liquidation of gold and dollar assets

Net foreign sales of gold to the United States, which amounted to $1.5 billion in 1948 and have totaled over $5 billion since the end of 1945, may be expected to decline sharply, in continuation of the declining trend since 1947. Net sales in the first half of 1949 were $244 million, and may possibly amount to around $500 million in 1949 and to over $300 million in fiscal 1950.

Foreign dollar bank balances, which increased in 1948 by $1.0 billion, after heavy declines since the end of 1945, may be expected to increase to a much smaller extent in 1949 and fiscal 1950. There was, in fact, a decrease in these balances by $115 million over the first six months of 1949. This decline was more than accounted for by a reduction in British dollar balances of $141 million; other countries, on balance, were accumulating to a small extent. Since the United Kingdom will probably attempt to replenish its balances during the remainder of the year, little or no net change in balances over 1949 may be expected, and possibly an accumulation in fiscal 1949-50 in the neighborhood of $.2 billion.

No estimate has been included for liquidation of foreign investments in the United States. Changes in foreign security holdings in this country over the first five months of the year have been negligible. The effect of combined gold and dollar estimates would amount to a net liquidation of $.5 billion in 1949 and $.2 billion in fiscal 1950.

Table I

Sources of Financing of U. S. Exports*
(In billions of dollars)

	1948	1949 (Estimated)			1950 (Estimated)	
	Actual	Jan.-June	July-Dec.	Calendar year	Jan.-June	Fiscal year
Imports of goods and services	10.5	5.0	4.7	9.7	4.2	8.9
Goods (recorded and unrecorded)	7.7	3.7	3.3	7.0	3.0	6.3
Investment income	.3	.1	.1	.3	.1	.2
Other services	2.5	1.2	1.3	2.4	1.1	2.4
U. S. Government aid	3.8	2.7	2.8	5.5	2.5	5.2
European Recovery Program	1.4	1.9	2.0	3.9	1.8	3.8
Civilian supplies for occupied areas	1.3	.5	.4	.9	.4	.9
Other 1/	1.5	.4	.4	.9	.3	.8
Receipts	-.4	-.2	-.1	-.3	-.1	-.2
U. S. Government loans	.9	.5	.2	.7	.1	.3
European Recovery Program	.5	.5	--	.5	.1	.1
Export-Import Bank 2/	.5	.1	.2	.2	.2	.3
British loan	.3	0	0	0	0	0
Other loans and receipts 3/	-.3	--	--	-.1	-.1	-.1
U. S. private aid, loans & investments	1.7	.6	.5	1.1	.5	.9
Remittances	.6	.3	.2	.5	.2	.4
Loans and investments, long-term	.9	.3	.3	.7	.3	.7
Loans, short-term	.1	-.1	-.1	-.2	-.1	-.2
International institutions	.4	.1	.1	.1	.1	.2
International Monetary Fund	.2	--	--	.1	--	--
International Bank	.2	--	.1	.1	.1	.1
Liquidation of foreign assets	.9	.4	.1	.5	0	0.2
Gold	1.5	.2	.3	.5	.1	.3
Dollar balances	-1.0	.1	-.1	--	-.1	-.2
Other	.3	--	--	--	--	--
Total financing	18.0	9.2	8.4	17.6	7.3	15.7
Errors and omissions	-1.2	-.9	-.5	-1.4	-.5	-1.0
Exports of goods and services	16.8	8.3	7.8	16.1	6.8	14.6
Current account surplus	6.3	3.3	3.1	6.4	2.6	5.8

* Figures may not add to totals because of rounding.

1/ Includes aid to China, Greece, Turkey, Philippine War Damage, IRO. In 1948 includes post-UNRRA and Interim Aid; in 1949 and 1950, includes Korea.

2/ Gross disbursement by Export-Import Bank only. Does not include lending by private banks at Export-Import Bank risk.

3/ Includes Surplus Property and Maritime Commission credits, net short-term lending, and long-term repayments.

Table II

Progress of ECA Operations
(In millions of dollars)

	Funds appropriated or authorized	Procurement authorized		Paid shipments	
		Month	Cumulative	Month	Cumulative
1948					
April	1/5,000	63	63	--	
May		144	238	--	
June		500	739	--	204
July		144	882	162	366
August		410	1,292	165	531
September		638	1,930	237	767
October		499	2,429	228	996
November		1,255	3,684	319	1,315
December		360	4,045	544	1,859
1949					
January		249	4,294	372	2,231
February		273	4,567	403	2,634
March		203	4,770	413	3,047
April	2/1,000	300	5,070	388	3,434
May		504	5,574	342	3,777
June		335	5,909	466	4,242

1/ Includes appropriations of $4 billion and authorization for a public debt transaction of $1 billion.

2/ Authorization for advances to be made by the RFC.

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THE FRENCH EXCHANGE STABILIZATION FUND   Robert Solomon

Recent legislation in France, which authorized the separation of the French Exchange Stabilization Fund from the French Treasury and its return to the Bank of France, has stimulated interest once again in the theoretical significance as well as the functions and practices of stabilization funds. This note is concerned primarily with the relationship to orthodox monetary policy of such institutions and with the significance of the recent change in France.

The Theory and Practice of Stabilization Funds

According to orthodox gold standard theory, an improvement in a country's balance of payments results in an inflow of gold which expands the credit base and increases the quantity of money, and therefore tends to raise prices in the country. A more modern version of this theory would be that the improved foreign balance tends to increase money income in the country. The inflow of gold increases bank reserves and thus permits the money supply to increase with the rising level of national income.

According to the "rules of the game" of gold standard theory the central bank in the gold-receiving country would increase its domestic assets as its foreign assets rose. This would involve a lowering of the bank rate and open market purchases of government securities in order to increase commercial bank reserves and thus encourage lending for investment purposes. This, in turn, would tend to raise incomes and prices in the country. In the contrary case, when a central bank lost gold it was expected to reduce its holdings of domestic assets, which would result in a reduction of commercial bank reserves and produce a greater degree of stringency in the money market. As a result spending and income would be reduced and prices would decline, thus leading to an improvement of the country's trade balance and reverse the tendency to lose gold and foreign exchange. Central bank action was expected, therefore, to reinforce the income and monetary effects of changes in gold reserves.

It appears, however, that the rules of the game were not consistently adhered to in the past. Whether by accident or design central banks' operations often tended to neutralize rather than reinforce the effects of changes in gold and foreign exchange reserves. 1/ In particular, when changes in gold reserves resulted from uneconomic movements of short term capital, efforts were made to prevent these movements from unduly influencing the domestic economy. Stabilization funds were sometimes used for this purpose. For example, one of the main purposes of the British Exchange Equalization Account was to break the link between changes in gold and foreign exchange reserves and changes in domestic bank reserves. The British Account accomplished this by buying Treasury securities to the same extent and at the same time that it sold gold, and by selling Treasury securities when it bought gold. Thus an outflow of capital would reduce commercial bank deposits but reserves were replenished when the Account purchased Treasury bills from the banks. Likewise when capital flowed in, the Account sold Treasury bills, offsetting the effect on bank reserves.

This function could have been performed directly by the central bank. However, it was deemed important to establish a separate fund, rather than to use the traditional central bank procedure, in order to prevent, or at least

1/ See Nurkse, International Currency Experience, League of Nations, 1944, p. 68

dampen, severe fluctuations in exchange rates which might result from, as well as induce, transfers of foreign balances. In order to minimize speculation, it seemed important for the stabilizing agency to operate secretly so that speculators would always be uncertain regarding the direction of its operations, but would be aware that it had adequate resources with which to influence the exchange rate.

Thus the British Account was established with the express purpose of preventing changes in foreign assets from unduly influencing the British economy. In a sense, its purpose was to break the rules of the game, or at least to prevent them from being followed. It is important, however, to emphasize that it was to a greater extent short-term capital or "hot money" movements rather than changes in trade balances that were being neutralized. As will be seen below, the operations of the French Fund during the thirties did conform with the rules of the game. Its only purpose was to attempt to stabilize the exchange rate.

The French Fund before the War

It will be recalled that after the Poincare stabilization in 1926, the French gold reserves increased tremendously as a result of a favorable trade balance and especially because of large inflows of capital. To a large extent, the latter consisted of French capital which was being repatriated as the owners regained confidence in the franc. The French gold reserve continued to increase even after the advent of the depression, partly because funds were being withdrawn from the United Kingdom.

When the British devalued and left the gold standard in 1931, the French monetary authorities determined to cling to the gold standard and to maintain the value of the franc which, at that time, was among the strongest currencies in Europe. To adjust to a falling world price level , deflation was advocated and attempted by the French monetary authorities.

This policy was by no means successful in maintaining the level of exports or in preventing Frenchmen from sending their capital abroad as the belief grew that the exchange rate could not be maintained. The large outflow of capital, on top of current account deficits, exerted steady pressure on the france and produced a substantial and almost continuous loss of gold. It should also be noted that the policy of deflation acted as a brake on efforts to reduce unemployment and later, to rearm.

France, of course, was not alone in retaining the gold standard after 1931. The so-called gold bloc, consisting of France, Belgium and Luxembourg, the Netherlands, Switzerland and Italy, was loosely formed in 1933 for the common purpose of defending gold parities. As the feeling grew that they would be unable to maintain their exchange rates, all of these countries suffered irregular losses of capital and in addition their exports appear to have suffered a greater set back than those of the countries which had depreciated.

The various French governments of the early thirties continued the efforts to maintain the value of the franc but the depreciation of the dollar in 1933-4 and of the Belgian belga in 1935 merely increased the speculation against the franc. Finally in September 1936, after having concluded the Tripartite Agreement with the U. S. and Britain which pledged the three countries against competitive devaluation, France unpegged the franc and allowed it to depreciate by 30 per cent.

At the same time the Exchange Stabilization Fund was established for the purpose of cooperating with the similar U. S. and British institutions to prevent large fluctuations in exchange rates. Under a protocol to the Tripartite agreement, the three countries adopted the policy of making their currencies convertible into gold to each other on a 24-hour basis. This made it possible for each of the funds to purchase the currencies of the others when necessary with the assurance that such foreign exchange could be converted into gold. It was agreed that this practice might be discontinued by any of the parties with 24 hours notice.

The function of the French Fund was to prevent fluctuations of the franc by buying or selling foreign currencies, mainly dollars and sterling. Even after devaluation, however, the capital flight persisted as a result of the threat of war, the economic and social policies of the Popular Front, and expectations of further devaluation. The franc could not be maintained at the September 1936 level. From July 1937 until the application of exchange controls upon the outbreak of the war, the Fund apparently confined itself to intervention in the foreign exchange market only sporadically to prevent the fall of the franc from becoming too precipitous. During occasional short periods of capital inflow the Fund purchased foreign exchange in order to prevent a sudden appreciation in the franc.

It should be noted that the French Fund, in contrast to the British, did not directly offset the internal monetary effects of capital movements or changes in trade balances since it maintained its franc assets on deposit at the Bank of France. The result was in conformity with the rules of the game: the outflow of capital tended to produce monetary stringency whereas capital inflow led to increased commercial bank reserves.

In its main function of maintaining the exchange rate relatively stable the Fund did not succeed, mainly because the reasons for the capital flight involved other factors than the desire to profit from an expected devaluation. There were severe political, social, and economic conflicts and the growing danger of war which hung over France throughout the thirties.

The Stabilization Fund Under the French Treasury

From February 1940 until July of this year, the franc assets of the Exchange Stabilization Fund were deposited with the Treasury rather than with the Bank of France. In contrast to the operations of the Fund in the thirties, this arrangement was contrary to the "rules of the game". In fact, this arrangement was theoretically more in conflict with orthodox monetary policy than the British system of the thirties, since it was likely to have direct income effects opposite to those caused by changes in the trade balance, whereas the operations of the British Exchange Equalization Account affected only bank reserves and therefore only indirectly influenced income.

If the Treasury's ability to borrow is limited as has been generally true in France, an inflow of gold or foreign exchange which is sold to the Treasury, rather than the central bank counteracts the expansionary effect of the improved foreign balance since it causes a reduction in the budget deficit or an increase in the budget surplus.

This occurs because the Government must increase taxes or decrease other expenditures in order to pay for the gold or foreign exchange. If, however, the Treasury were able to increase its borrowing to cover the additional payments required by the gold inflow, then the income effects of the improved balance of payments would not differ from those which would occur if the gold were sold to the central bank. The effect on bank reserves and therefore on potential credit expansion would also be the same if the increased borrowing came from the central bank. They would, however, be smaller if the increased Treasury borrowing came from the commercial banks.

On the other hand, an outflow of gold and foreign exchange, would result in an increase in the domestic currency resources of the Treasury. If, as may be largely true in France, Treasury expenditures are determined by the amount of receipts, the deflationary influence of the balance of payments deficit would tend to be offset by increased government expenditures. However, if the increased Treasury receipts were not utilized to increase effective demand direct the income effect would be similar to that under the "rules of the game", and the monetary effect would be the same if the increased Treasury receipts were kept on deposit at the central bank or utilized to pay off government debt to the central bank. On the other hand, retirement of debt held by the commercial banks would be intermediate in its effect on potential credit expansion.

This system violated the "rules of the game" because of conscious polic and ineffective fiscal control and not because the formal arrangement differed from what is called for by gold standard theory. By the same token, it should not be assumed that the transfer of the Fund to the Bank of France heralds a return to monetary orthodoxy.

The Recent Change

In July of this year the French Parliament passed a law providing that the funds needed by the Stabilization Fund will be advanced to it by the Bank of France and that the Fund will maintain its franc assets on deposit at the Bank of France. In addition, the Bank is authorized to buy and sell gold and foreign exchange which is acquired by the Fund, thus permitting the Fund to alter the relative proportions of its domestic and foreign assets if it becomes necessary.

This action has been interpreted as a return by the French monetary authorities to more orthodox policies. It is significant, however, that the change occurred at a time when the French balance of payments had begun to improve to the extent where the Fund was accumulating foreign exchange. The result was that the Treasury was experiencing a drain of francs to the Fund to finance this accumulation. It would appear that the action was motivated more by expediency thay by principle.

In any case as long as exchange control is maintained, the functions of the Fund will be confined to buying and selling foreign exchange at fixed rates which are maintained either by decree or, as in the case of the official "free market", mainly by the volume of exchange permits issued. In the latter case, of course, the Fund technically does prevent a possible unintended appreciation by standing ready to purchase all foreign exchange offered.

If it were decided to reduce or eliminate exchange control, the Exchange Stabilization Fund would again have an important function. If this happens it is to be hoped that economic conditions in France do not give rise to a recurrence of capital flight and that the bitter experience of the thirties is not repeated.

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LONG-TERM INVESTMENT IN THE
U.S. - U.K. ZONES OF WESTERN GERMANY

Gordon B. Grimwood

Economic Developments Since Currency Reform

The Western German currency reform of June 20, 1948, 1/ with its transition from a barter to a money economy, brought into the foreground once again the problem of how to obtain long-term investment funds. Prior to that time this problem had been of secondary interest; there had been no incentive to increase production and existing productive facilities were not fully utilized.

By restoring economic incentive, the currency reform caused a spectacular growth in production, increasing from 51 per cent of 1936 in June 1948 to 90 per cent in March 1949. In June 1949, however, the production index dropped to 85 per cent of the 1936 level. This increased rate of production, which so far has been achieved mainly by taking up the slack in productive facilities, has brought into sharp focus the needs for long-term credits to finance the restoration and expansion of capital equipment. At the same time it has become extremely difficult for industry to find such credits.

Immediately after the currency reform, there was considerable indiscriminate spending of "initial quotas" and current income in order to purchase the commodities that emerged from hoarding, which resulted in extremely rapid turnovers and high profits for producers and distributors of consumer goods. The general decontrol of all prices except those of a few basic goods accellerated this development. These windfall profits were either spent on consumption or, to a large extent, reinvested in the enterprises in which they originated, and thus have become unavailable for the capital-starved producers' goods industries.

Although bank credit to private individuals and business enterprises in Western Germany has expanded steadily since the currency reform, rising from DM 1.4 billion in July 1948 to DM 6.2 billion in May 1949, the great majority of these loans have been short-term advances. Left with an extremely low capital ratio as a result of inflation and currency reform, the banking system has been unable to make genuine long-term investment credit available to industry. Moreover, the bizonal central banking authorities frown upon all proposals to provide investment funds through credit expansion, since they fear this might renew the inflationary pressures which developed during the second half of 1948. 2/ However, the capital market has failed to close the gap and between June 1948 and May 1949 issues of industrial bonds and stocks totaled only DM 0.1 billion. Capital goods industries thus were forced to borrow on short term in order to make essential

1/ See this Review July 13, 1948, and March 8, 1949.

2/ See this Review August 16, 1949.

capital investments, and were forced to pay interest rates ranging from 6 per cent to 9 per cent.

Private savings, from which long-term investment credits should eventually come, have suffered several adverse developments since the currency reform. The backlog of demand accumulated since 1939, the distrust in the currency following inflation and currency reform, as well as the rise in prices during the second half of 1948 raised the propensity to consume far above normal. The decision of the occupation authorities in October 1948 to cancel 70 per cent of the deposits blocked on June 20, 1948, also gave impetus to this development. The average wage earner not only was unable to save but in order to meet living expenses was forced to draw upon savings which might have been left after the cancellation of blocked deposits. Savings accounts in savings banks began to recover only when the "planned deflation" began to take effect in early 1949, but during the first six months of 1949 the increase amounted to only DM 400 million, most of which is regarded as deferred consumption rather than true savings.

Another aspect of the financial development which has hampered the accumulation of investment funds in the Bizone since currency reform has been the tax structure. The tax reform, promulgated by the occupation authorities on June 20, 1948, had reduced income and wage taxes by an average of one-third and had replaced a sliding scale of corporate taxes of from 35 per cent to 65 per cent with a flat tax rate of 50 per cent. As the purchasing power of money became somewhat stabilized, it became apparent that this tax rate was so high as to encourage widespread tax evasion. A second ordinance, designed to encourage reinvestment of profits, was approved on April 18, 1949. This ordinance raised exemptions and provided for certain tax concessions to corporations and individual enterprises. However, it has not changed the fundamental situation, and substantial funds still are kept away from the legitimate capital market either to escape detection of their origin or to avoid taxation of their earnings.

Reconstruction Loan Corporation

In order to meet the urgent needs for capital, which was already apparent at the time of the currency reform, a Reconstruction Loan Corporation was established to supply all branches of the economy with medium- and long-term credits — to the extent that other credit institutions were unable to furnish such credits. The Corporation was to be capitalized at DM 1,000,000 to be raised (1) by the issue of bearer bonds; (2) by borrowing from the German Bizonal Economic Administration or raising loans abroad; and (3) from counterpart funds of GARIOA and ECA. 1/ The Corporation was

1/ German currency deposited by German importers in payment for foreign aid-financed imports. GARIOA (Government and Relief in Occupied Areas) appropriations are used to finance imports of essential foodstuffs, seeds, fertilizer, and petroleum products. ECA allocations are used mainly to finance imports of raw materials and capital equipment.

also given authority, under certain conditions, to borrow on short term from the Bank Deutscher Laender. At the present time, however, the Corporation has received only about DM 350 million, all of which has come from GARIOA or ECA counterpart, although the Bizonal Economic Administration has made an allocation of DM 500,000 for the Reconstruction Loan Corporation in its supplemental budget for the fiscal year 1949-50. The Corporation has not yet attempted to raise funds on the market, but it is expected that such an offer will be made in the near future.

Under the Reconstruction Loan Corporation's charter; credits are limited to DM 3,000 million plus an equal amount in guarantees of loans of other credit institutions. Short-term advances may constitute only 10 per cent of the medium- and long-term credits.

Pending the organization of the Reconstruction Loan Corporation, the occupational authorities were forced to take some direct steps in the field of investment credit to meet immediate situations. For example, in December 1948 the Bipartite Control Office instructed the Bizonal Economic Council to make an appropriation of DM 34 million as an emergency subsidy to keep marginal coal mines in production.

Another important segment of the Bizone's economy which had to be financed prior to the organization of the Reconstruction Loan Corporation was the German federal railway, the Reichsbahn. Despite several rate changes designed to increase revenue, the Reichsbahn was running an operating deficit and at the same time required substantial capital expenditures to maintain operations. After assuring themselves that certain internal economies had been effected, the Military Governors in December 1948 arranged from various sources short-term loans in the amount of DM 85 million and long-term loans in the amount of DM 800 million, including DM 200 million from GARIOA counterpart funds.

In April 1949, the Reconstruction Loan Corporation submitted to the occupation authorities a so-called "At Once" program calling for the immediate expenditure of DM 388 million to be allocated as follows: electric power, DM 170 million; mining, DM 135 million; transport, (excluding the Reichsbahn) DM 5 million; and "other", DM 78 million. This program was approved by the Military Governors, together with a supplemental recommendation providing DM 53 million for agriculture and DM 90 million for housing, or a total of DM 531 million. All funds for this "At Once" program were to be made available to the Reconstruction Loan Corporation from GARIOA counterpart funds. By the end of May 1949, the Corporation had made loans totaling DM 113 million from these funds.

Bizonal Economic Administration Program for 1949-1950

The revised program for the fiscal year 1949-1950, submitted by the Bizonal Economic Administration to the Organization for European Economic Cooperation, envisages a gross investment of DM 16 billion and a net investment in fixed capital equipment of DM 7.3 billion, or 19.5 per cent and 9.1 per cent, respectively, of estimated gross national product for the year.

These figures compare with an investment of 18.5 per cent and9.4 per cent of gross national product in 1936. In addition to the net fixed capital investment of DM 7.3 billion necessary during 1949-1950, it is estimated that DM 1.2 billion will be needed for inventory and working capital, making a total net investment of DM 8.5 billion. It should be borne in mind, however, that the estimated gross national product for 1949-1950 is only 91 per cent of 1936, while the population in the U. S. - U. K. Zones has increased to about 42 million in 1949 as compared with 33 million in 1936; the amount earmarked for investment, therefore, involves a per capita consumption of about 28 per cent lower than in 1936.

The Bizonal Economic Administration has estimated that DM 6 billion can be made available from the domestic economy during 1949-1950, leaving a total of DM 2.5 billion to be financed by foreign aid (GARIOA and ECA counterpart funds). The available sources of capital in the domestic economy are broken down in the following manner:

(in millions of DM)

Fixed Capital:		
Public funds	1,950	
Self financing	1,200	
Savings bank funds	700	
Public subscription of securities	350	
Private insurance funds	300	
Social insurance funds	300	
		4,800
Working Capital:		
Self-financing funds	200	
Bank credit	1,000	
		1,200
Total		6,000

Of the DM 1,950 million to be supplied from public funds, DM 1,550 million is to come from the state governments, DM 300 million from the municipalities and communities, and DM 100 million from an equalization fund receiving interest and amortization of former Reichsmark mortgages. During the first quarter of 1949, total budgetary receipts of the state governments were running at an annual rate of DM 15,738 million, of which an estimated 10 per cent will be available for investment.

Self-financing is the largest segment of the long-term investment credit field over which the government will have no control. The amount of self-financing was very substantial last year, being estimated at approximately DM 8 billion from June 1948 to June 1949. 1/ This figure, however, included large windfall profits obtained by producers and distributors of consumer goods which will not be available this year. The Second Ordinance for Tax Reform of April 1949 was designed primarily to encourage reinvestment of profits and might serve to meet the target amount during the fiscal year. Public opinion in Germany is sharply divided on the issue of whether

1/ See this *Review*, August 16, 1949.

the Government should try to bring those investments under control or encourage private investment at the expense of public investments. The recent political victory of the Christian Democratic Union, champions of free enterprise, would seem to indicate that taxes on business profits will be further reduced and that the use of profits will remain relatively free from control.

The Bizonal Economic Administration estimates that savings banks in the U. S. - U. K. Zones will accumulate savings deposits of DM 1,000 million during the fiscal year, DM 700 million of which will be available for long-term investment. This sum can be controlled by the Reconstruction Loan Corporation only if the Corporation can induce the savings banks to invest it in the bonds to be issued by the Corporation, either voluntarily or under the pressure of a proposed Investment Planning Board. Savings during the first six months of 1949 have increased at lower than the estimated annual rate, but the expected expansion of production to 95 per cent of 1936 and continued stability of the value of money should result in a higher propensity to save during the fiscal year 1949-50.

The prospects of floating new securities are very dim at the present time, as was evidenced by the failure of the recent 6 per cent Reichsbahn loan (a subscription of DM 50 - 60 million instead of an expected DM 350 million). This tendency may change if the level of the general economy continues to rise. The results of two large loans to be floated by the Reconstruction Loan Corporation, one bearing interest at 5 1/2 per cent for the purpose of financing industry and the other a tax-exempt issue bearing interest at 3 1/2 per cent for the purpose of housing construction, will be significant in this respect.

The last four items on the list of domestic sources of investment funds have been estimated on the basis of 1949 first-quarter figures and would seem to be within reason for 1949-1950.

Turning to the problem of foreign aid financing of the deficit of DM 2.5 billion, it should be noted that as of May 1949 imports financed by foreign aid, either GARIOA or ECA, were running at an annual rate of DM 3,208 million, about half of which were ECA imports. Although ECA counterpart is almost intact (a release of DM 105 million was approved very recently), GARIOA counterpart has been largely spent or committed for the fiscal year. It is estimated by the occupation authorities that not more than DM 2,000 million will be available for investment purposes during 1949-1950. Additional releases from ECA counterpart are being considered but will be delayed pending the results of the Reconstruction Loan Corporation's bond issue and the submission of a long-term investment program which is satisfactory to ECA.

Permission for foreign investment in the Bizone has seemed imminent since currency reform but as yet the prohibition of such investment has not been removed, partly because of difficulties in solving the thorny problem of Germany's outstanding foreign debts. On account of these difficulties and of the present economic and political uncertainties, it is believed that private foreign investment will not be significant this year even if it were again permitted.

Under the circumstances outlined above, it would seem that the most feasible solution to the investment problem in Western Germany is the immediate use of counterpart funds and other public funds, plus a judicious financing of investment by credit expansion. Private savings, from which investment funds must eventually come, will not be directed into such investment until a more secure level of economic activity has been reached; such a level, on the other hand, cannot be reached until investment funds are forthcoming. The use of public funds and controlled credit expansion in a well-directed investment program during the intervening period should hasten the time when savings can again take over their traditional role in capital replacement and accumulation.