Recent Monetary and Financial Policies Abroad

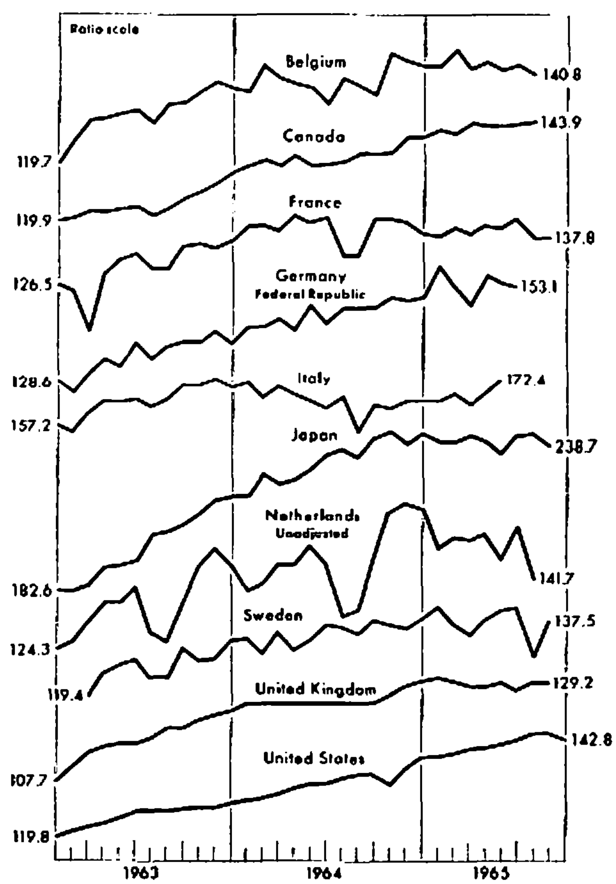
The strong measures adopted by the United Kingdom to curb the country's serious balance of payments deficit commanded the most attention among the various policy measures taken by the major industrial countries abroad during April-October of this year.[1] Other countries, too, leaned in the direction of restraint during the spring and summer—particularly Germany, but also Austria, Sweden, the Netherlands, Switzerland, and Canada. In other major countries—France, Belgium, Italy, and Japan—economic conditions permitted some relaxation of previously instituted restraint policies and led in some cases to the adoption of monetary and fiscal stimuli.

Economic trends in major industrial countries have been quite mixed recently. High-level activity and some price pressures continue in most of these countries, but in a few instances industrial production has declined and gross national product growth slowed. Thus, there is some evidence of a cyclical pattern abroad, although recessions have typically remained short and shallow with expansion dominant on balance. The timing of fluctuations in economic activity has varied considerably from country to country (see Chart I). For example, Italy reached a production peak in late 1963, followed by a recession from which the country is still recovering. Production leveled off in mid-1964 in France, peaked later in the year in Japan and Belgium, and apparently slowed down in early 1965 in the United Kingdom and Sweden. Throughout the past two years, on the other hand, industrial production continued to rise in Canada and Germany, and probably also in the Netherlands, although at slower rates in 1965 than before. Consumer prices moved upward in all these countries and in some—particularly the United Kingdom, the Netherlands, Germany, and Japan—the price increases threatened to gain momentum this year; in Italy the rise in prices has been slower than in 1964 (see Chart II). These variations in the rate of growth of economic activity and in price developments have substantially influenced external payments positions. In some of the countries

Chart I

INDUSTRIAL PRODUCTION IN MAJOR COUNTRIES

Seasonally adjusted; 1957-59=100



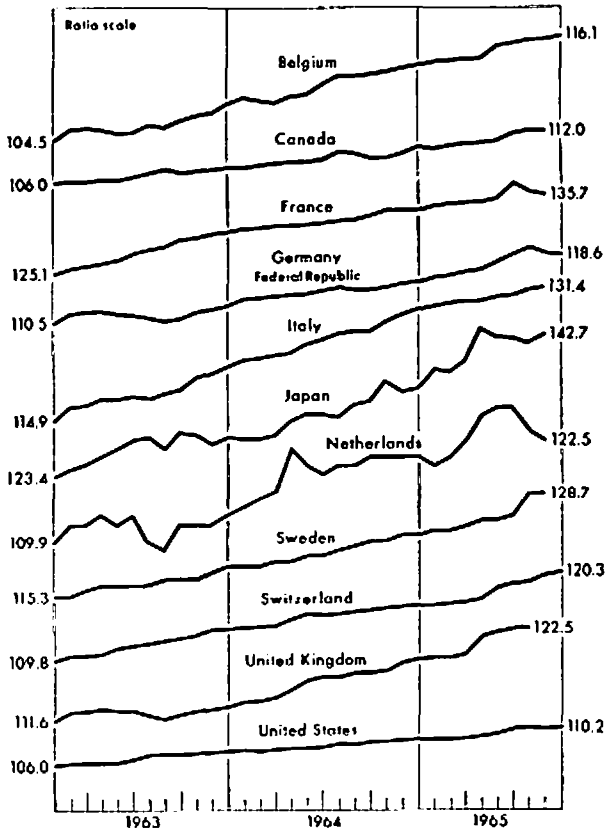
Sources: Organisation for Economic Cooperation and Development, monthly statistical bulletins; national statistics.

[1] For a discussion of foreign economic policy measures in 1964 and early 1965, see "International Monetary and Financial Developments", this *Review* (October 1964), pp. 196-201, and "Recent Economic Policy Measures in Industrial Countries Abroad", *ibid.* (April 1965), pp. 74-78.

Chart II

CONSUMER PRICES IN MAJOR COUNTRIES

1957-59=100



Sources: Organization for Economic Cooperation and Development, monthly statistical bulletins; national statistics.

where domestic output has grown more slowly—such as France and Italy—the trade account improved, while in most countries that have experienced exceptional growth or inflationary pressures, the trade account deteriorated.

UNITED KINGDOM

During the period under review, the British government sought to develop a combination of domestic and foreign economic policies that would be stringent enough to curb excess domestic demand, retard the increase of prices and costs, and diminish the serious external payments gap. Restrictive measures adopted since last October have attacked these problems on a very broad front; they have included tax increases and reforms, tightening of domestic credit, retrenchment of government spending programs, curbs on imports, tighter exchange controls, improved assistance to exporters, and a firmer incomes policy. In general, the government has placed major emphasis on rapid progress toward external balance and on regenerating full confidence in sterling. Cumulatively, the British program has come to represent a formidable restraint package, and its effect on the domestic economy has been increasingly felt in recent months.

Several measures, described in the April issue of this *Review*, were taken by the new British government last fall, and by early 1965, the balance of payments did in fact begin to show some improvement. But wage increases continued well in excess of the 3½ per cent per annum official guideline, while retail prices advanced at an annual rate of 3.8 per cent in the six months ended March 31, 1965, and wholesale prices of manufactured goods rose at a 4.6 per cent annual rate during this period. Thus, the need for further corrective action was evident.

This need has been recognized in a sequence of actions taken over recent months. The April budget provided for tax increases, and tighter controls on capital outflows were introduced at the same time. Through May and June, monetary policy was tightened by several notches. Toward the end of July, government expenditures were cut back (with a moratorium on the placing of new contracts), and further measures were introduced to lend strength to the foreign trade and capital accounts. Most recently, incomes policy has been strengthened, and a move has been made toward long-range planning for sound growth of the British economy.

In the April budget the basic income tax rate was raised to 41¼ per cent from 38¾ per cent, and the capital gains tax was broadened to include longer term gains. Also, taxes on tobacco and alcoholic beverages were increased, as were motor vehicle license fees. In the area of tax reform, the government introduced a major revision of business income taxation, which favors reinvestment of corporate earnings in the United Kingdom while tending to discourage British corporate investment abroad.

Several steps taken at the time of the April budget message were designed specifically to improve the external position. The standards for making foreign exchange available for British direct investment abroad were tightened, and United Kingdom residents who wished to convert into sterling the foreign exchange proceeds of certain capital transactions—sales of nonsterling securities and direct investments—were required to dispose of 25 per cent of these proceeds through the official market for sterling, rather than converting them entirely through the "investment dollar" market.[2] Moreover, controls over foreign travel allowances and the repatriation of foreign exchange proceeds of exports were stiffened.

On the expenditures side of the April budget, government current and capital spending programs called for substantial increases despite certain savings in military aircraft procurement. Nevertheless, if one takes account of the proposed increases in taxation together with the restrictive measures adopted earlier, external payments balance during the course of 1966 was anticipated.

Over the next few months, however, the economy remained on a fairly expansionary path, and this development—judging from the monthly foreign trade returns, growing wage pressure, and exceptionally tight labor market conditions—posed a threat to the government's schedule for restoring payments balance in 1966. To meet this threat, the authorities again tightened credit policy. At the end of April, the London clearing banks and the Scottish banks were asked to make special cash deposits with the Bank of England, amounting to 1 per cent and 0.5 per cent respectively of their total deposits. In early May, the clearing banks, along with a wide range of other financial institutions, were asked to limit the annual growth of lending to the private sector to 5 per cent in the year ending March 1966, and to curtail loans for imports and nonessential purposes while giving preference to exports and activities contributing directly to exports.

On June 3, the Bank of England lowered its discount rate to 6 per cent from the 7 per cent that had been in force since the previous November (see table). The move was designed more to demonstrate confidence in current policies than to signal a shift toward ease. At the same time, the government raised minimum instalment credit downpayments from 20 per cent to 25 per cent on automobiles, and from 10 per cent to 15 per cent on most other consumer durables.

Tangible evidence that the economy was responding to the restrictive measures was slow to emerge. Imports rebounded in March-May in response to the end of the United States dock strike and the reduction of the import surcharge from 15 per cent to 10 per cent on April 27; meanwhile, exports showed a tendency to remain level. Thus, the trade deficit widened in those months. In June, although imports fell back, exports fell also, thus seeming to confirm doubts as to whether the needed export growth would be forthcoming.

CHANGES IN SELECTED FOREIGN CENTRAL BANK DISCOUNT RATES, 1964-65

In per cent

Country	Date	New rate	Change
Belgium	1964: July 3	4¾	+ ½
Canada	1964: November 24	4¼	+ ¼
Denmark	1964: June 11	6½	+ 1
France	1965: April 8	3½	− ½
Germany	1965: January 22	3½	+ ½
	August 13	4	+ ½
Japan	1964: March 18	6.57	+ 0.73
	1965: January 9	6.205	− 0.365
	April 3	5.84	− 0.365
	June 26	5.475	− 0.365
Netherlands	1964: January 6	4	+ ½
	June 4	4½	+ ½
South Africa	1964: July 15	4	+ ½
	December 8	4½	+ ½
	1965: March 5	5	+ ½
Sweden	1964: January 31	4½	+ ½
	November 6	5	+ ½
	1965: April 9	5½	+ ½
Switzerland	1964: July 3	2½	+ ½
United Kingdom	1964: February 27	5	+ 1
	November 23	7	+ 2
	1965: June 3	6	− 1

Consequently the British government took additional restrictive measures at the end of July to bolster the program already in force. Expenditures delays and cutbacks were announced for all levels of government, including especially outlays overseas but also current and capital spending of the local governments and the nationalized industries. Furthermore, certain welfare programs—such as the guaranteed income plan, completely free health service, and favorable interest rates on mortgages for owner-occupied residential buildings—were postponed. Thus, tightened fiscal policy was added to the existing monetary stringency. Private spending was also curbed through a reduction in local government mortgage lending, stricter licensing of private construction projects, and a reduction of the maximum repayment period on almost all instalment sales to thirty months from thirty-six months.

Also in July, the external payments gap was again tackled specifically: it was required that all new direct foreign investment by British residents outside the sterling area be financed by funds obtained from the investment dollar market or from abroad; and the sale of certain for-

[2] The authorities use this market to limit nonsterling investment by United Kingdom residents. The latter must obtain the foreign exchange needed for portfolio or direct investments by bidding for it in a market where the supply of foreign exchange is derived from approved sales by British residents of nonsterling-area securities or other approved assets.

eign exchange receipts of United Kingdom residents (proceeds of life insurance policies, immigrants' assets, and savings from employment abroad) was shifted to the official market for sterling. In addition, the Bank of England ordered a curtailment of advance payments for imports, requested the banking community to extend no further loans when prima facie evidence suggested that the funds would finance imports, and announced stricter supervision of credit facilities available to the British subsidiaries of foreign corporations. To assist exports, the minimum size of loan contracts eligible for coverage by the government's Export Credits Guarantee Department (ECGD) was halved for the second time this year (to £25,000). Also, the banks agreed to provide short-term export credits, against an unconditional ECGD guarantee for all such credits of between thirty days and two years, at the official discount rate instead of about 1 per cent above that rate for credit which previously was not guaranteed.

The British government's most recent actions have been designed to make existing curbs more effective and to deepen its attack on the country's external payments problem. In September, the Minister of Economic Affairs sought and obtained a promise of union-management cooperation in a program designed to give "early warning" of impending price or wage increases in key sectors. The government intends to introduce legislation giving the National Board for Prices and Incomes broad investigatory responsibilities, and giving the government the power to delay wage or price increases until after the Board's report.

Late in September, the authorities published a National Plan calling for a 25 per cent increase in real output by 1970. A crucial aim of the growth program is a balance of payments sufficiently strengthened over the next five years to meet the repayment of maturing external debt and bolster official reserves. It is recognized that the achievement of these goals will require exceptional increases in productivity and a very substantial increase in industrial investment. The government asserted the crucial importance of concerted national action to eliminate restrictive practices by both management and labor and thereby improve the competitive performance of the economy.

It is now becoming evident that the measures taken by the British authorities over the past year have resulted in substantial progress toward eliminating Britain's external payments deficit. During the first half of 1965 the deficit on current and long-term capital account was only one third that of the same period last year, while the second quarter produced a surplus for the first time in two years. The improvement reflected both an improved trade balance and a sharp drop in capital exports. The recent strengthening of sterling and the third-quarter decline in the trade deficit suggest continued progress in eliminating the payments deficit.

RESTRAINT IN OTHER COUNTRIES

A number of other countries have found some degree of restraint necessary in the period under review. Germany and Sweden—faced with rising prices, deteriorating trade balances, and congested capital markets—have considerably reinforced restrictive measures in recent months. In Austria, the Netherlands, Switzerland, and Canada, where inflationary pressures have been somewhat milder or trends in payments balances more favorable, restraints have been less severe.

The German economy has long been operating at virtually full capacity, and the shortage of labor has been marked. Since the turn of the year, the upward movement of prices has apparently accelerated somewhat, and an over-all balance of payments deficit emerged during the second quarter. Money market conditions have tightened perceptibly, while heavy demands from both private and public borrowers, including the federal government, have pushed up long-term interest rates. In May, the German Federal Bank halted its price support operations for public-sector bonds, with a resulting rise in effective yields on 6 per cent public-authority bonds from 6.7 per cent in April to 7.6 per cent in July. In view of the mounting pressures on long-term rates, a stop on new flotations of federal, state, and municipal bonds was imposed at the end of July. This ban was lifted in September, but representatives of federal, provincial, and municipal governments and of the Federal Bank have held regular consultations with a view to limiting public-sector issues and hence preventing any further substantial rise in interest rates. Largely in recognition of developments in the financial markets, the Federal Bank on August 13 raised its discount rate from 3½ per cent to 4 per cent, the second increase in less than seven months.

Sweden, too, moved to offset inflationary pressures by both monetary and fiscal measures. On April 9, the central bank raised its discount rate (for the second time in six months) from 5 per cent to 5½ per cent, the highest level since the early 1930's. At the same time, it boosted from 10 per cent to 11 per cent the penalty rate for discounts in excess of the established ceilings. Soon thereafter, the government moved to make more resources available for residential construction and industrial investment by reducing its own construction expenditures by 10 per cent, and it urged the local authorities to make similar cutbacks. An increase in the general sales tax from 6.4 per cent to 10 per cent became effective on July 1, with increases in old-age pensions and children's allowances to ease the impact.

Austria has continued to experience price and wage pressures, and the policy of monetary restraint, initiated last fall, was intensified during the period under review. Commercial bank reserve requirements for the large banks were raised further, to 12 per cent of sight and time deposits and to 10 per cent of savings deposits. In addition, the central bank engaged in open market sales of Treasury paper. (Recent legislation provided for the conversion of a part of the National Bank's claims on the government into marketable securities.) On the fiscal side, government expenditures were cut back to avoid additional borrowing when tax receipts failed to come up to expectations.

In the Netherlands, economic policy has remained fairly restrictive in the face of rising domestic investment, pressure on the financial markets, and some inflow of funds from abroad. The Netherlands Bank has maintained the requirement that banks deposit with the central bank amounts equal to the excess of their loans over the established ceilings (although these ceilings were raised slightly in September). But despite the restrictive efforts the economy experienced sharp pressures on costs and prices during the first eight months of this year. These included a substantial wage increase in early 1965, the negotiation of a 2 per cent wage bonus payable partly in July and partly in December, and the inclusion of a cost-of-living escalator clause in recent longer term wage contracts. The pressures were reinforced by a reduction in income taxes at midyear (which had its inception in a wage-tax package worked out at the end of 1964). In view of the fact that the cost-of-living index rose by nearly 5 per cent in the first seven months of the year—equal to the increase expected for the whole year by the Dutch planning authorities—official price investigations in twenty-one economic sectors were initiated in September. In one sector, hotels and restaurants, prices have already been rolled back from a level of 10 per cent higher to one 4 per cent higher than that of October 1, 1964. As regards fiscal policy, the government's 1966 budget calls for a 9 per cent increase in expenditures and a tax reduction of $28 equivalent per taxpayer. However, increases in indirect taxes, the growing tax base, and obligatory purchases of savings certificates (in an amount equal to the tax reduction) are expected to make it unnecessary for the government to increase its market borrowings.

Swiss economic policy has also remained on the restrictive side, especially in view of the continued upward drift of prices and last year's decision to reduce the number of foreign workers (who account for about one third of the total Swiss labor force). The main elements of economic policy remain those introduced in 1964 and since extended by national referendum: limitations on increases in bank credit, limits on construction permits, control over the timing of new securities flotations of both domestic and foreign borrowers, and restrictions on the inflow of foreign funds. Since the present control powers are temporary, the Swiss National Bank has proposed legislation under which it would receive broader powers, including the right to establish minimum reserve requirements and the possibility of greater scope with respect to open market operations.

Conditions in the Canadian money and capital markets tightened somewhat during the period under review. The growth of aggregate demand has quickened during 1965, spurred by a rise in business investment, by inventory accumulation, and by a moderate rise in exports (to which the recent large wheat sales to Russia and China will be added). The resulting resources strain has apparently led to a slight shift in monetary policy aimed at moderating the pace of domestic expansion. Achievement of this objective was facilitated by some withdrawals of United States funds from Canada as a result of the United States Voluntary Foreign Credit Restraint Program. In September, the three-month Treasury bill rate reached 4.15 per cent, the highest since November 1962. As Canadian banks attempted to maintain their liquidity positions through sales of longer term securities, rising rates in the money market were transmitted to the medium- and long-term markets as well, and the Treasury nudged rates a bit higher by a mid-August bond offering priced below the market. Also in August, Prime Minister Pearson called for restraint in public and private capital spending and, to set an example, announced the postponement or spacing-out of some government construction projects.

COUNTRIES TURNING TOWARD STIMULATIVE POLICIES

In four countries in which earlier restrictive measures had been followed by a substantial slowing-down of economic growth—France, Belgium, Italy, and Japan—mildly stimulative policies adopted in late 1964 or early 1965 were continued in the period under review. Because prices in all these countries still have been rising and because the margin of unemployed resources has been thin in most cases, stimulatory efforts have remained cautious.

The Bank of France lowered its discount rate from 4 per cent to 3½ per cent on April 8. Shortly thereafter the basic rate for calculating interest rates on commercial bank loans was lowered, for the second time in 1965. In April, the French government liberalized loan standards on government-subsidized low-interest home mortgage loans. Ceilings on the permissible annual percentage increase in commercial bank credit were eliminated in June; for some months, however, they had not been reached. Other aspects of monetary policy—rediscount ceilings and liquidity ratios in particular—have remained relatively restrictive. In September a number of steps were taken to promote economic growth by altering the structure of French financial institutions (see the final section of this article). As to fiscal policy, the budget prepared for 1966 reflects the French government's firm commitment to maintain the balance between receipts and expenditures achieved in 1964 and, in all probability, in 1965. Estimates of budget receipts to meet larger expenditures are based on a higher rate of growth than has recently been realized, but the recent upturn in economic activity affords support for official expectations.

The Belgian authorities have proceeded with similar caution. Certain government investment projects—frozen the year before when inflation was more threatening—were resumed in April, and public works projects that had been scheduled for later this year were pushed forward. In July, both the 1 per cent commercial bank reserve requirement, imposed a year earlier, and the ceilings on bank credit expansion were removed. The central bank nevertheless requested the banks to observe caution in granting loans and not to increase loans for construction and consumer purchases.

The Italian economy has shown signs of a gradual recovery from the recession that developed early last year. So far, the recovery has been mainly limited to a group of export and consumer goods industries, such as iron and steel, automobiles, and chemicals. Activity in other key industries, especially textiles and construction, has not yet regained momentum. With a strong export performance, with import demand slow to recover to prerecession levels, and with excellent tourist receipts, Italy's external payments were in surplus by close to $1.1 billion in the first eight months of the year. This external surplus has increased commercial bank liquidity, and the banks have responded by reducing their net foreign indebtedness by about $500 million. There has been little increase, however, in bank loans to domestic borrowers, as loan demand has remained relatively slack. In view of the partial character of the recovery thus far, special efforts are now being applied to stimulate the weaker sectors of the economy. Thus, in August, the government approved a number of steps to aid the textile industry, including tax exemptions, official contributions toward modernization efforts, retraining of displaced workers, and extended unemployment benefits. Provisions for reviving the building industry are now being considered, as are measures for speeding up the government's investment program.

In Japan, the restrictive policy followed by the authorities through most of 1964 succeeded in reducing the country's balance of payments deficit, but the growth of output had virtually stopped by the end of the year, unemployment and excess plant capacity began to develop, and the stock market displayed considerable weakness. Although the Bank of Japan began to move toward an easier money policy in December 1964 and also lent its support to the stock market, the adverse trends continued into mid-1965. In these circumstances, some industrial and financial corporations found themselves overextended, and a few highly publicized bankruptcies occurred, which increased nervousness in Japanese financial markets. Thus, during the spring the Japanese authorities initiated a series of moves to reestablish confidence and promote recovery. In May, special credit arrangements were provided to securities houses while the central bank continued to support the securities market. The Bank of Japan's discount rate was reduced in April and again in June. It now stands at 5.475 per cent, the lowest since 1950. Ceilings on the expansion of commercial bank credit were abolished in June, and in July the minimum cash reserve requirements for banks and other financial institutions were reduced, while the Bank of Japan made substantial open market purchases. These monetary measures have substantially lowered the interest rates prime industrial and commercial borrowers must pay.

Japan's fiscal policy is also becoming more stimulative. Deficits in the investment budget have resulted in modest but increasing over-all budgetary deficits since 1962. This year's deficit is likely to be over $800 million equivalent, as a result of a decision taken in July to restore about $280 million of previously postponed expenditures and the enactment in August of a supplementary investment budget of roughly $560 million (including increased loans to finance exports, housing, public utilities, and small and medium-sized business enterprises). For the fiscal year beginning in April 1966, the government plans to introduce legislation permitting a deficit in the general account budget—prohibited since 1949—and substantially reducing the corporate income taxes levied by the central government. The size of the over-all deficit likely to result has not yet been determined.

SOME INSTITUTIONAL CHANGES ABROAD

The recent tapering-off in the rate of output growth in many countries at a time when prices have continued to drift upward has led to considerable thought abroad about changing institutional arrangements in ways which would lead to further productivity gains without imparting inflationary impulses to national economies.

Several institutional changes of considerable general interest have in fact been introduced in major countries abroad in 1965. In Germany, two steps have been taken to promote workers' savings and to direct them toward productive investment. In April, the German parliament approved a partial transfer from government to private ownership of the shares of a large mining and utilities concern—the third such "privatization" in recent years. The new shares were sold in small denominations at attractive prices to encourage widespread ownership and to attract small savings. The following month a second law provided a limited tax exemption on benefits paid by employers into blocked savings accounts of their employees.

In France recent (and pending) tax legislation and rulings by the monetary authorities are designed to effect important structural changes in French financial institutions. The over-all objectives of these reforms are, first, to increase the proportion of income saved and, second, to promote more effective utilization of savings. The first objective is to be furthered by partial or complete tax relief on income from various kinds of personal savings. Specifically, tax exemptions are provided for the first 500 francs of bond interest, interest on savings accounts up to 15,000 francs, and income (and capital gains) accruing from ten-year savings plans that require regular investments in securities. Tax reductions are to apply to a broader range of interest and dividend income. To promote the second objective, the distinction between commercial banks and investment banks *(banques d'affaires)* will be reduced by allowing the former to accept deposits of more than two years and the latter to accept sight deposits without restriction. Both types of banks will be expected to adapt the structure of their assets to actual changes in the maturity of their deposit liabilities. Recent changes in Bank of France discount policy are designed to accomplish two objectives: first, to encourage the commercial banks to move into longer term and more varied lending and, second, to have them rely more heavily on private rather than on central bank resources. To promote the first objective, the Bank will rediscount medium-term paper with maturities of up to seven years (rather than the former five years) and also a wider variety of export paper. However, in line with the second objective, the central bank will in most cases limit rediscounts to paper with three years or less to run to maturity, rather than five years as previously, and will charge a 0.50 per cent penalty for discounts in the two to three years' maturity range.