Recent Economic Policy Measures in Industrial Countries Abroad

Since the beginning of 1967, there has been a progressive relaxation of policies of monetary restraint in a number of industrial countries abroad. During 1966, monetary policy had been tightened in many countries to contain acute inflationary pressures or to resist a deterioration in the balance of payments.[1] In the absence of sufficiently restrictive fiscal action, interest rates had soared to their highest levels in the postwar period. Later in the year, however, conditions in the financial markets eased slightly, as demand pressures subsided in several previously overheated economies. By early 1967, policy formulation in virtually all countries took place in a context of better balance between demands and resource availabilities. At the same time, considerable progress had been made in some countries toward the correction of payments imbalances. In view of the slower growth in some countries, credit conditions were allowed to ease slightly toward the end of 1966. Since the start of the year, there has been a further and more rapid reversal of last year's upward spiral of interest rates—a reversal marked by repeated reductions in central bank discount rates. In Germany, the discount rate was lowered early in January in the first of a series of overt moves toward monetary ease. This change was quickly followed by reductions in discount rates in Canada, Belgium, and Sweden. In subsequent months, discount rates were cut further in these countries and credit conditions eased in other industrial countries as well. Following the relaxation of monetary restraint abroad and with the recovery of confidence in sterling, the Bank of England has lowered the bank rate in several steps.

[1] For a detailed discussion of developments in 1966, see "Recent Economic Policy Measures in Industrial Countries Abroad", this *Review* (June 1966), pages 144-49, and (December 1966), pages 268-73.

UNITED KINGDOM

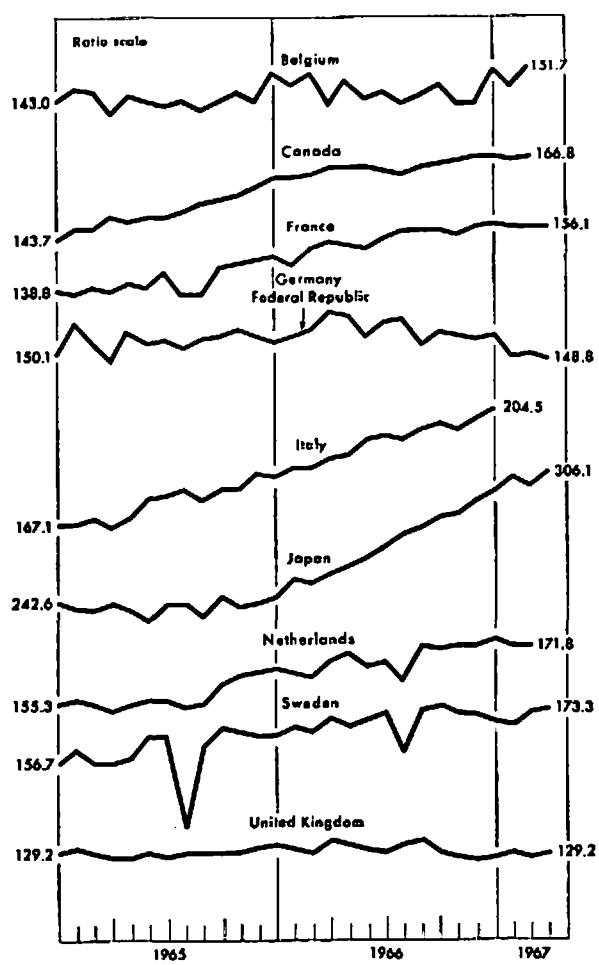
Since the adoption of a sweeping stabilization program in July 1966, inflationary pressures in the United Kingdom have eased considerably and during the fourth quarter there was a dramatic improvement in the balance of payments. The introduction in July of more stringent restrictions on instalment purchases, in combination with the effects of an earlier policy of credit restraint, led almost immediately to a reduction in sales of consumer durables. At the same time there was a pronounced change in business expectations, which led to some downward revision of investment plans. New housing starts also dropped as a consequence of an emerging squeeze on consumers' disposable income and the jolt to business confidence. Moreover, the rate of inventory accumulation, which had been fairly rapid earlier in the year, fell sharply in the fourth quarter—partly because of the decline in final sales and partly because imports were postponed in anticipation of the removal at the end of November of the remaining part (10 per cent) of the import surcharge that had been introduced in October 1964. Despite a recovery in exports, industrial production turned down in the autumn months (see Chart I). As employers reappraised their labor requirements, employment began to fall and the seasonally adjusted unemployment rate rose from 1.2 per cent in June to almost 2 per cent by the year-end. In conjunction with the decline in overall demand, the standstill on wages and prices, adopted as part of the July program, proved very effective. Hourly wage rates, which rose at an annual rate of almost 7 per cent during the first half of 1966, remained virtually unchanged during the second half. Although retail prices rose by 1½ per cent from July to December, this change largely reflected an increase in indirect taxes imposed in July rather than an erosion of the price freeze.

In the closing months of the year, the authorities took a number of steps to bolster business confidence and cushion the readjustment. In November, the Bank of England pointed out that outstanding credit extended by the clearing banks was below the ceiling on loans to the private sector, which had been renewed as part of the July stabilization program, and made it clear that banks had the resources to meet all justified demands from priority borrowers. Then, on December 1, the government increased the amount of direct grants for certain investment projects —from 40 per cent to 45 per cent of expenditures in the so-called development areas and from 20 per cent to 25 per cent elsewhere. By the turn of the year, there were signs that the domestic economy had begun to stabilize after the sharp adjustment in the autumn. Consumer expenditures began to pick up in the early months of 1967, industrial production appeared to have bottomed out, the seasonally adjusted unemployment rate was only slightly higher than at the year-end, and the fall in demand for bank credit was beginning to moderate.

Chart I

INDUSTRIAL PRODUCTION IN MAJOR COUNTRIES

Seasonally adjusted; 1957-59=100

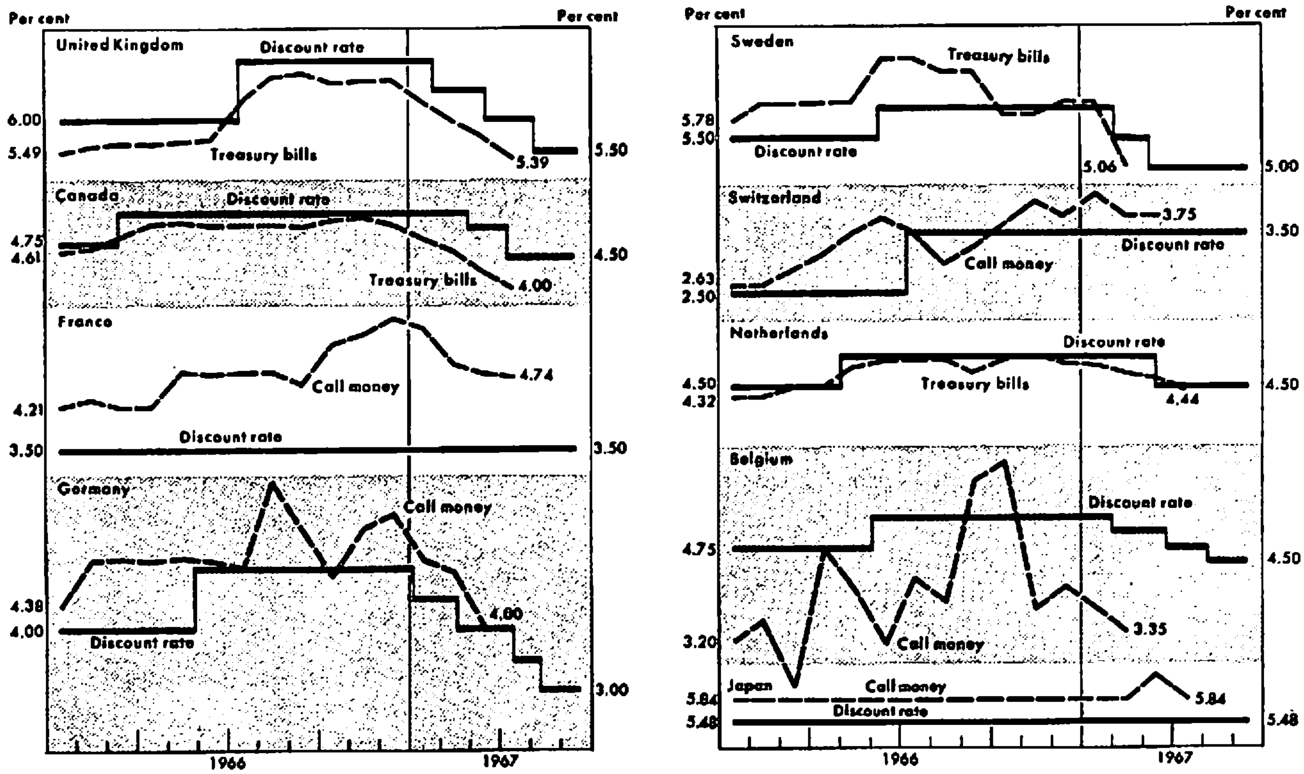


Sources: National statistics; Organization for Economic Cooperation and Development, monthly statistical bulletins.

Externally, the austerity program began to exert a corrective effect on the balance of payments in the closing months of 1966. After allowance for seasonal factors, exports were significantly higher in the fourth quarter while imports fell sharply, partly in anticipation of the removal of the import surcharge at the end of November. Despite a rebound in import deliveries in December, the average level of imports in the fourth quarter was 7 per cent lower than in the first nine months of the year, clearly suggesting that the July measures had begun to take hold. With the turnabout in the trade balance, the current account moved into substantial surplus and, after allowing for the repayments on the United States and Canadian government loans, resumed in full in the fourth quarter, there was an underlying improvement in the long-term capital account as well. Thus, after having run a very large balance-of-payments deficit during the first three quarters of 1966, the United Kingdom developed a $380 million current-account surplus (seasonally adjusted) in the last quarter alone, and the balance of payments moved into substantial surplus. The trade balance moved back into slight deficit during the first quarter of 1967, but the overall balance on current and long-term capital account appears to have remained in surplus thus far this year. Moreover, with the further recovery of confidence in sterling and the reversal of "leads and lags", foreigners continued to rebuild their sterling balances. During the first four months of the year, the Bank of England was able to increase its reserves by substantial amounts, even after repaying all its drawings under the Federal Reserve swap facility and fully liquidating the short-term credits provided by other central banks last summer. In addition, the Bank of England in January paid off in their entirety the special credits obtained earlier from the Federal Reserve and the United States Treasury.[2] This pattern of gradual improvement was interrupted in April, when the trade balance worsened, with imports rising much faster than exports. However, in May the United Kingdom was able to repay, six months ahead of schedule, $405 million owed to the International Monetary Fund under a 1964

[2] See Charles A. Coombs, "Treasury and Federal Reserve Foreign Exchange Operations", this *Review* (March 1967), pages 43-51.

Chart II
CENTRAL BANK DISCOUNT RATES AND SHORT-TERM INTEREST RATES IN SELECTED COUNTRIES



drawing and an $80 million loan obtained from Switzerland in 1964. With the repayment, the United Kingdom's remaining indebtedness to the IMF due this year was reduced to $393 million. Sterling drawings by other IMF members are expected to reduce this indebtedness further.

Against this background of considerable progress toward restoration of external and internal balance, the Bank of England on January 26 lowered the bank rate from its crisis level of 7 per cent to 6½ per cent (see Chart II). This was followed by another ½ percentage point cut in mid-March after a slight easing in money market rates. However, clearing bank loans (seasonally adjusted) declined in January but leveled out in February. As a result, the margin between outstanding advances and the ceiling on bank loans continued to widen. In April the ceiling was removed from the clearing banks and the Scottish banks, but at the same time it was announced that special deposits by these banks would be used more flexibly to control the volume of bank credit, and the qualitative guidance covering the direction of bank lending was reaffirmed. So far as all other banks were concerned, the ceiling was to remain in force until suitable alternative methods of credit control could be arranged. Moreover, the few tax changes announced in the budget in April were designed to be essentially neutral in their impact on the economy, reflecting the government's view that it "should not take any substantial action to influence demand just now". The budget was well received abroad and, following further reductions in interest rates at home and abroad, the bank rate was cut to 5½ per cent in early May.

RELAXATION OF MONETARY RESTRAINT IN OTHER INDUSTRIAL COUNTRIES

The slowdown in economic activity in Germany, which first became apparent in the spring of 1966, developed at an unexpectedly rapid rate in the second half of the year. Fixed private investment weakened steadily, while spending by state and local authorities was particularly hard hit by the stringency in the money and capital markets. The slack in domestic demand was reflected in a marked slowdown of imports and a sharp rise in exports. The resultant improvement on trade account was the major force behind the reemergence of a payments surplus in the latter half of 1966. These trends continued into the new year. By March, the level of industrial production, seasonally adjusted, had fallen 7 per cent below its earlier peak and the unemployment rate had reached an unusually high 2.2 per cent. However, in April there were some signs that the economy was beginning to respond to a number of expansionary policy measures.

Conditions in the financial markets had already begun to ease slightly toward the end of 1966, as the emerging balance-of-payments surplus resulted in a large inflow of liquid funds. Then, early in January, the German Federal Bank lowered its discount rate from 5 per cent to 4½ per cent in the first of a succession of overt steps designed to lower interest rates and to expand bank liquidity. On February 1, reserve requirements against nonresident deposits were reduced to the levels applied to the banks' domestic liabilities. This move was followed by another ½ percentage point cut in the discount rate in mid-February and by an across-the-board 10 per cent reduction in reserve requirements, effective on March 1. However, the pull of relatively high money rates abroad, particularly in the Euro-currency markets, resulted in a substantial outflow of liquid funds, which tended to brake the decline in domestic interest rates during the first two months of the year. The authorities cut the discount rate to 3½ per cent on April 14 and, after a further reduction in reserve requirements, the discount rate was reduced by another ½ percentage point on May 11. With interest rates abroad also declining, these moves were more fully reflected in lower domestic interest rates.

The shift toward monetary ease in Germany has been accompanied by a more flexible use of fiscal policy. Thus, in an effort to stimulate investment, the authorities have introduced liberalized depreciation allowances for expenditures on fixed assets incurred before the end of October 1967. The regular budget is expected to be in deficit, as the slowdown in activity is likely to lead to a shortfall of revenues below the budget estimates. In addition to the regular budget, the new coalition government also adopted in January a strongly expansionary "contingency budget", which provides for a substantial increase in public investment. In order to alleviate any strains in the financial markets resulting from the government's increased borrowing requirements, the German Federal Bank has indicated its readiness to help finance the Federal deficit.

The Canadian economic situation and the policies adopted to meet it have also altered in recent months. The pace of the business expansion lost some of its upward momentum during the latter part of 1966, reflecting in part the effects of monetary and fiscal actions taken earlier in the year to moderate demand pressures.[3] Despite the slower growth in final demand, the average increase in wages continued to be far in excess of productivity gains, and upward pressures on prices were still very strong. Fiscal policy remained oriented toward the need to contain inflationary pressures through September, when the government reduced certain planned expenditures. Moreover, the government announced that additional taxes would soon be proposed in a supplementary autumn budget to cover higher social security payments which were scheduled to begin in January. However, the posture of policy shifted in subsequent months, as evidence accumulated that the investment boom was running out of steam and that industrial production had leveled off. Credit conditions were allowed to ease considerably late in the year. Commercial bank liquidity continued to increase after the turn of the year, and bond yields declined substantially over a wide range of maturities. On January 30, the Bank of Canada lowered its discount rate from 5¼ per cent to 5 per cent. The discount rate was again reduced on April 7, to 4½ per cent, partly reflecting the change in credit conditions that had already occurred and partly in response to a concurrent ½ percentage point cut in the Federal Reserve discount rate.

This shift in monetary policy has been supported by the removal of earlier fiscal restraints on business investment. To be sure, the supplementary budget, which had been postponed until mid-December, called for a modest increase in sales taxes, but this increase was calculated to do no more than offset higher social security benefits. Early in March, it was announced that the refundable tax on corporate profits, which had been introduced in May 1966, would be terminated on April 1, 1967—a full seven months before it was originally scheduled to expire. At the same time, depreciation allowances, which had been cut last year in an effort to restrain an exceptionally large increase in planned business investment, were restored to their earlier levels. The budget for fiscal 1968, presented to Parliament on June 2, was designed to provide a mod-

[3] For a discussion of these measures, see "Monetary and Fiscal Policy in Canada", this *Review* (August 1966), pages 182-87.

erate offset to the continuing softness of private demand. With expenditures expected to rise more rapidly than revenues, the budgetary deficit is estimated at Can.$740 million, compared with the actual outturn of Can.$428 million for the fiscal year ended on March 31. In view of the large increase in expenditures and continuing upward pressures on costs and prices, the government was not prepared to reduce taxes on personal or corporate income. However, it announced that the 6 per cent sales tax on machinery and equipment, which was originally scheduled to expire next April, would be removed immediately to encourage a recovery of private investment.

In the Netherlands, demand pressures abated in the latter part of 1966, as a restrictive monetary policy and certain anti-inflationary fiscal measures began to take effect. Although fixed private investment continued to rise, there was some slowdown in public investment, particularly by local authorities, and the growth in exports subsided as the year-end approached. The rate of increase in prices leveled off around the turn of the year, and at the same time there was an unexpectedly rapid rise in unemployment. Accordingly, the government announced in January that cash grants would be made available to attract more industry to those areas of the country where structural unemployment is a particularly serious problem. With manufacturers' order backlogs dwindling, the Netherlands Bank reduced its discount rate from 5 per cent to 4½ per cent on March 15, and also took steps which, in effect, raised the quantitative limit on credit expansion imposed on Dutch commercial banks. In a fiscal move designed to alleviate the strains in Dutch capital markets and achieve a better balance between monetary and fiscal measures, a planned increase in turnover taxes originally scheduled to take effect next year was advanced by six months to July 1, 1967, while a planned reduction in income taxes originally scheduled for January 1, 1967 was postponed until midyear.

The pace of the Swedish expansion slowed down in the latter part of 1966 in response to generally weaker demand conditions both domestically and abroad. The growth of investment moderated, labor shortages became less marked, and Sweden's external position improved as imports stabilized. When signs of a slowdown in economic activity became apparent in the summer months, the Bank of Sweden engaged in sizable open market purchases and bank liquidity eased considerably in the second half of the year. This shift in monetary policy has continued thus far this year. The Bank of Sweden cut the discount rate from 6 per cent to 5½ per cent on February 3 and then to 5 per cent on March 10, in line with declining domestic and foreign interest rates. Despite the slowdown in industrial activity, upward pressures on costs and prices continued to increase through the early months of 1967, partly as a result of a large retroactive increase in wages that was paid at the end of 1966. In order to moderate consumption and restrain continuing cost increases, the budget, presented to Parliament last January, called for a substantial increase in sales and excise taxes, some of which have already gone into effect.

In Belgium, monetary policy remained generally restrictive through the end of 1966 in an effort to contain continuing inflationary pressures. Conditions in the financial markets tightened from the spring through the end of 1966, as domestic credit demands accelerated and the emergence of a balance-of-payments deficit strained the liquidity of the banking system. Industrial production, after having remained generally stable through most of 1966, picked up around the turn of the year. In subsequent months, however, the pace of economic activity slackened again and, as earlier tightness in the labor market abated, there was some relaxation of monetary policy. The National Bank of Belgium reduced its discount rate from 5¼ per cent to 5 per cent on February 2. As market rates of interest, both domestic and foreign, continued to move downward, the discount rate was lowered on March 23 and again on May 11—by ¼ percentage point each time. In a complementary fiscal move, the government obtained special powers from Parliament early in April to enable it to institute by decree a number of measures designed to stimulate investment and to speed up regional development programs. Under these powers, certain indirect taxes were quickly raised, but the higher revenues are to be used primarily to increase public investment. Decrees were also issued to provide tax relief for new investment, particularly in newly defined development areas.

ITALY, JAPAN, FRANCE, AND SWITZERLAND

Italian economic policy remained expansionary throughout 1966. The recovery in economic activity, which had been hesitant and unevenly distributed throughout most of 1965, accelerated and became more broadly based during 1966. A rise in exports was reinforced by resurgence of domestic consumption, and in the latter part of the year there was a recovery of fixed private investment. For 1966 as a whole, industrial production was almost 12 per cent higher than in 1965 while the overall advance in real gross national product (GNP) was 5.5 per cent. Fragmentary information for the early months of 1967 suggests that the advance has remained brisk in most industrial sectors and that upward pressures on wage rates and prices are still fairly moderate despite a continued decline in the unemployment rate. Within this context of noninflationary growth, monetary policy has remained relatively easy. Despite a substantial increase in credit demands, particularly by the public sector, and a sharp rise in interest rates abroad, Italian interest rates held steady in 1966, as the Bank of Italy expanded its advances and rediscounts to the banking system. The banks continued to make large short-term investments abroad, particularly in Euro-dollars, and thereby helped to ease the strain in that market resulting from the strong demand from United States banks and German borrowers. In the closing months of 1966, the growth in exports tapered off and there was a substantial increase in long-term capital outflows, reflecting higher interest rates abroad. Nevertheless, the overall balance of payments remained in substantial surplus. Since the start of the year, however, there has been some reversal of earlier outflows of bank funds, as the rise in domestic loan demands has outstripped the increase in deposits.

The Japanese recovery from the 1965 recession gathered momentum in 1966, as a strong surge in fixed private investment was reinforced by a sharp increase in exports. For the year as a whole, GNP advanced by about 9 per cent in real terms and the level of industrial production increased by 14 per cent. There was a substantial outflow of long-term capital last year, but the normal cyclical deterioration on trade account was partially offset by increased United States military expenditures in connection with the Vietnam conflict, and the balance of payments moved into surplus. Thus far this year, new and unfilled orders for machinery have continued to rise, import demand has accelerated, and there have been some signs of emerging labor shortages. Since the turn of the year the trade balance, seasonally adjusted, has moved into substantial deficit, but the deterioration of trade account has been partly offset by renewed inflows of short-term funds, as Japanese importers and other borrowers have taken advantage of rapidly declining interest rates abroad to meet part of their financing requirements. Despite the strong demand for bank credit, the average interest rate on bank loans continued its downward trend through February. Credit conditions tightened somewhat early in March, but then eased again, when the Bank of Japan increased its limit on loans to large city banks and supplied increased funds to the private sector through purchases of securities. However, in view of the unexpectedly rapid recovery in investment and the resultant deterioration in the trade balance, the government, in a special session of the Diet in mid-March, warned businessmen to exercise caution in new plant and equipment expenditures. Moreover, the budget estimates for the fiscal year that began on April 1 provide for a smaller overall deficit, and the government explained that this was designed to prevent overheating.

In France, real GNP rose by almost 5 per cent for 1966 as a whole but the pace of the expansion slowed down in the latter half of the year. Fixed private investment, stimulated in part by a 10 per cent tax credit granted in May 1966, continued to rise but consumer demand was somewhat sluggish as the year-end approached and the growth in exports leveled off. Consumer prices advanced by less than 3 per cent during the year, and the labor market has remained free of the strains that were present before the 1963 stabilization program. However, the overall balance of payments moved into deficit in the fourth quarter of 1966, when the slowdown in Germany and some other countries resulted in a substantial deterioration in the trade balance. Against this background of somewhat slower growth, French economic policy has remained cautiously expansionary. Interest rates moved upward during the fourth quarter of 1966 in response to higher interest rates in other financial centers, but this trend has been partially reversed this year. Fiscal operations provided a mild stimulus for the economy last year, and the 1967 budget, which was presented to Parliament last December, is also expected to be moderately expansionary.

While there has been little change in the general stance of monetary and fiscal policy, the authorities implemented a number of broad-gauged structural reforms. In January, they began to replace the existing required liquidity ratio with a new system of cash reserve requirements for the banking system. The former compulsory assets ratio, under which a portfolio of Treasury bills, medium-term commercial paper, and certain other assets had to be held as a proportion of sight and time deposits, was in principle abolished, but as an interim measure minimum holdings of medium-term paper by banks were prescribed in order to facilitate the transition to the new reserve system. The controls on financial relations with other countries were also relaxed toward the end of January. As a rule, all exchange transactions and payments are now freely permitted except those which specifically remain subject to control, such as direct investments. Furthermore, nonresidents are now allowed to issue securities in the French capital market on the same terms as domestic borrowers, subject to prior authorization. Such clearance also is required for borrowing abroad by French residents. However, French banks are exempt from this control and can freely lend and borrow abroad.

In Switzerland, there has been little change in the posture of monetary policy, which is still oriented toward the need to contain inflationary pressures. During the fourth quarter of 1966, interest rates moved upward in response to relatively high interest rates in neighboring countries.

As conditions in the domestic money market tightened, the commercial banks raised the rate for savings deposits by ¼ per cent to 3¾ per cent early in January. Moreover, interest rates on long-term maturities also moved up further, despite strict controls on new bond issues. The 1964 emergency legislation, which provided for the introduction of quantitative ceilings on bank credit, expired in March. In view of the persistence of inflationary pressures, however, the Swiss National Bank asked the commercial banks to limit the overall growth of their short- and long-term advances during 1967 to 7 per cent of the amount outstanding at the end of 1966—an increase slightly less than the actual expansion last year.

CONCLUDING REMARKS

The acute tensions that developed in financial markets last year dramatized the need for more flexible use of other policy instruments. The need for monetary restraint would have been less compelling and the rise in interest rates might have been less pronounced, if fiscal measures had been used more vigorously to cope with inflationary strains. But in most of the countries discussed here, fiscal action was delayed or insufficiently restrictive and the burden of restraint was largely carried by monetary policy. At this particular juncture, the need for credit restraint has become less acute in most European countries, and indeed several countries have already moved in the direction of monetary ease. This shift has been most pronounced in Germany, where domestic economic conditions called for active stimulus. However, in view of the high sensitivity of capital movements to international interest rate differentials, the shift toward monetary ease in Germany was partly diluted by short-term capital outflows. Movements of short-term funds have often placed limits on the ability of monetary policy to adapt to changing domestic requirements, but the continued development of the Euro-currency markets, which have become the focal points for international capital movements, has narrowed these limits. Thus, the need for flexibility in fiscal policy may be equally urgent, when domestic economic conditions call for stimulus.