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ECONOMIC POLICY IN WESTERN EUROPE

REPORT

FOR THE

JOINT ECONOMIC COMMITTEE

ON

CONFERENCES IN WESTERN EUROPE

WITH

SELECTED MATERIALS ASSEMBLED BY THE COMMITTEE STAFF

JANUARY 1959

Printed for the use of the Joint Economic Committee

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LETTER OF TRANSMITTAL

JANUARY 2, 1959.

To Members of the Joint Economic Committee:

Transmitted herewith is a report based on a series of conferences on economic policy matters held in seven countries of Western Europe late in 1958. The origin of these conferences is to be found in our committee's report of February 27, 1958, on the January 1958 Economic Report of the President. It was noted there that many countries in the free world, in pursuing policies to encourage economic growth, have been confronted with the problem of persistent inflationary pressures. As part of its overall inquiry into factors underlying general postwar price movements, the committee expressed its intention of examining the economic policies employed in these countries. To this end four members of the committee, Representatives Reuss, Talle, Kilburn, and I, accompanied by members of the staff, conferred with Government and private experts in the capitals of France, Germany, Italy, the Netherlands, Sweden, and the United Kingdom.

We were extremely fortunate in being able to meet with members of government and other key legislators, including ministers of economics, of finance, and of planning, and with central bank governors, as well as with principal national and international civil servants and private bankers, industrialists, economists, and journalists. These conferences were informal and covered a wide range of subject matter, with particular emphasis on public economic policies for promoting high rates of economic growth, employment, and output while maintaining stability in the general price level. Unfortunately, it was not possible for all four members to visit every country studied. The report accordingly represents a pooling of our individual observations. It includes certain statistical tables that have been prepared for us by the committee staff and there is an appendix of materials that were assembled by the staff in preparation for the conferences.

There was also a conference in Zurich, which contributed significantly to our understanding of West European experience. Considerations of time unfortunately precluded additional conferences in Switzerland. It is a matter of regret, too, that similar considerations prevented the inclusion of Belgium among the countries studied. In the materials prepared for use of the members, which appear in the appendix, both countries are represented, but the report itself does not deal with their individual economic experience and policies.

Several reservations must necessarily be recognized in reporting on these conferences. Limitations of time precluded inquiries as exhaustive as would have been preferred. Moreover, the extreme diversity of major elements in the economic development and in the social, political, and economic institutions of Western Europe precludes unqualified recommendation for the United States of any of the policy techniques employed there. Nevertheless, the experience of these countries may offer lessons that could be helpful in strengthening public economic policies in the United States.

We wish to record here our deep appreciation of the great courtesy extended us by the officials, legislators, and private citizens with whom we conferred. They were extremely generous of their time and very frank in their discussion of the matters in which the committee had expressed interest. We hope that the interest and cooperation they demonstrated will in some measure have been repaid by the ideas and impressions which they may have gained from our exchange of views.

We wish to acknowledge also the very great assistance provided us by the heads of mission, Foreign Service officers, and Treasury representatives, who made all arrangements for these conferences following an initial planning trip by two members of the committee staff. Their courtesy and efficient handling made our experience as enjoyable as it was rewarding. Underlying all these arrangements was the courteous and indispensable service of the Office of Congressional Relations, Department of State.

While the conferences were the major aspect of the study, the materials presented in the appendix are believed to be of interest to other Members of Congress and to the public generally. Much of the information is not generally available in this country, and policymakers and students of economic policy should find it helpful to have these materials assembled in this form. Unfortunately, some items of considerable value have had to be omitted because no English version was available. This is the principal factor accounting for the considerable variation in the range of the subject matter covered by the materials for the several countries.

In the collection and selection of these materials, the committee has had the cooperation and assistance of the economic staffs of the respective American embassies. Their knowledge of available materials served to bring to the committee's attention a number of important items which otherwise it would not have been possible to consider, including unclassified memorandums prepared by the economic staffs themselves and made available for committee use by the Department of State. Some of the items thus made available, however, are among those that, although included for use last fall, are omitted here because they were of essentially current nature rather than of continuing relevance.

We are indebted to the director and staff of the Division of International Finance, Board of Governors of the Federal Reserve System, for descriptive material on the several national banking systems prepared at our request for inclusion in the appendix and to the Legislative Reference Service of the Library of Congress for a bibliography appearing there, also prepared on request. We greatly appreciate the courtesy of the several copyright holders whose permission to reprint items appearing in the appendix is acknowledged in a footnote to each such title.

Sincerely yours,

WRIGHT PATMAN,
Chairman.

CONTENTS

ECONOMIC POLICY IN WESTERN EUROPE

I

Western European Economic Development Since 1948

Since 1948 economic development in Western Europe as a whole has been quite rapid.[1] As in the United States, however, economic expansion has not proceeded smoothly. Broadly speaking, four major phases stand out: (1) the postwar reconstruction, completed about 1950; (2) the Korean war period of mid-1950 to 1953; (3) the post-Korean expansion in 1953–57; and (4) the 1957–58 recession.

POSTWAR RECONSTRUCTION, 1948–50

Economic reconstruction in most of Western Europe was undertaken under seriously adverse conditions. Available resources, per capita, were substantially—at least 10 percent—below 1938 levels. Fiscal and monetary systems were badly disorganized. Industrial and agricultural output were below prewar levels. Serious balance-of-payment problems prevailed. Economic activity in general was confronted by chaotic market conditions.

It was, of course, recognition of these difficulties that in 1948 led the United States to offer economic assistance. With this assistance, gross national product in real terms increased on the average by nearly 8 percent a year for all OEEC member countries combined. On a per capita basis, real GNP increased by nearly 7 percent annually. Industrial production rose on the average by about 11½ percent. This rapid rise in output was associated with a marked growth in the annual rate of real gross domestic fixed capital formation and in real private consumption.

At the same time, substantial increases in the price level were experienced in several OEEC countries. Strong and increasing demands from all sectors of economic activity were confronted by disrupted lines of supply and by serious resource limitations. These demand pressures were not offset by monetary and fiscal restraints. Despite the monetary reforms effected in several countries, the supply of money was far above prewar levels, from 2½ times as much in Sweden to 8 times in France and 33 times in Italy. In some cases, another factor adding to the upward pressure in domestic price levels was the rise of world prices, transmitted through the large volume of imports on which all these countries must rely.

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[1] Throughout the report the statistics published by the Organisation for European Economic Co-operation (OEEC), which was formed in 1948 by the countries participating in the Marshall Plan, have been used as representing Western Europe. For a note concerning these data, see table 1, below. The six countries reported on here have more than half of the total population and account for fully four-fifths of the output of all 17 Member countries combined. The other 11 are: Austria, Belgium, Denmark, Greece, Iceland, Ireland, Luxemburg, Portugal, Switzerland, Trieste, and Turkey.

While public policies pursued in these countries assuredly contributed to a realization of gains in output and productive capacity, it is clear that private demands arising out of the losses and sacrifices of the war years were the principal stimulant. The critical importance of American assistance in the form of Marshall plan aid and loans lay in providing the real resources needed to get the productive machinery of Western Europe out of low gear.

THE KOREAN WAR PERIOD, 1950–53

By mid-1950, much of the basic economic reconstruction had been achieved or the conditions established for further progress in this respect. The outbreak of hostilities in Korea exerted, on the whole, a disruptive influence. Many OEEC member countries undertook to increase materially their defense preparations. At the same time, the speculative buying spree set off by Korea impelled drastic efforts to limit inflationary developments. The public policy restraints adopted in response to balance-of-payment pressures, combined with the sharp rise in prices in world markets, significantly damped down the rate of economic expansion in most OEEC countries.

For example, expansion of GNP in real terms slowed to an overall annual rate of 4.3 percent. On a per capita basis, real GNP increased by about 3.2 percent, on the average in this period. Expansion of industrial production slowed to 5.2 percent during this period from an annual average of 11.6 percent in 1948–50. Gross domestic fixed capital formation continued to expand, but at less than half the rate realized during the preceding period. The rate of increase in real private consumption also declined substantially.

At the same time, prices rose quite rapidly and quite generally. Between early 1950 and mid-1951, the average cost of merchandise imports from outside Europe rose by 45 percent, and led to marked increases in the prices of finished products in Europe. The average price of finished goods rose in a range of 5–10 percent per year during this period.

POST-KOREAN EXPANSION, 1953–57

Rapid expansion of economic activity in most sectors characterized post-Korean experience well into 1957. In most cases, this expansion reflected initially the dissipation of the price pressures associated with the Korean war period inventory accumulation and defense efforts and the availability of greater productive capacity accumulated during the preceding 6 years. In the latter part of the period, expanding economic activity was quite generally associated with an investment boom, paralleling the similar development in the United States.

During the entire period from the end of 1953 through 1957, GNP in real terms rose at an average annual rate of 4.9 percent for all OEEC countries combined. Industrial production increased on the average at an annual rate of 7 percent. Gross domestic fixed capital formation expanded on the average by 7.9 percent annually. Real private consumption increased by about 4.5 percent annually. Employment conditions showed steady improvement.

The latter part of this period was marked by mounting price pressures. In large part, these were associated with increasing demand pressures from private and public investment activity. Restrictive public policies were not fully effective in containing these inflationary strains.

THE 1957-58 RECESSION

By mid-1957, Western Europe was entering a fourth phase of postwar development—a period of reduced rate of growth, some growth in unemployment, and a slowing in many countries of the price advance. Late 1957 and early 1958 were recession months, therefore, marked not so much by declines in total output such as occurred in the United States as by slowing rates of growth. In the second half of 1958, signs of renewed strength in economic activity in general began to appear as exports stabilized or improved, public expenditures and investments rose, and inventory liquidation began to be reversed.

COMPARISONS WITH UNITED STATES EXPERIENCE

There are, of course, limitations upon the closeness of the comparisons which may be made between the performance of the United States economy and those of Western European countries. Significant differences in the concepts and methods of measuring major economic aggregates limit comparability. In addition, the relatively low levels of production and employment in many of these countries in the immediate postwar period serve to make even modest increases in the level of economic activity appear quite large percentagewise. Throughout the period, moreover, movements of world prices were more challenging to stabilization policies in most European countries than in the United States, because of the greater dependence of the former on foreign trade.

Despite these reservations, economic accomplishments in Western Europe are quite impressive. While living standards remain substantially lower than in the United States, the increases in productive capacity, updating of production methods, improvements in housing, and the expansion of utilities and communications and of energy sources which have already been achieved, coupled with programs for further gains, hold considerable promise for general prosperity.

Focus and Techniques of Public Economic Policy

As might be expected, the focus of public economic policies has changed since the early postwar years. While problems of reconstruction and replacement of facilities and rehabilitation of human resources remain, increasing emphasis now is placed on providing the basis for long-run economic growth. Emphasis has shifted from recovery to progress. Similarly, although the hyperinflationary developments of the early postwar years have been brought under control, the problem of dealing with persistent creeping inflation remains. As in the United States, therefore, public economic policies in Western Europe are concerned with achieving high rates of employment, output, and growth in productive capacity, while maintaining stability in the price level.

Pursuit of these objectives is both facilitated and made more difficult in Western Europe by the relatively heavy dependence of these nations on foreign trade. The balance of payments of each of these countries with the rest of the world acts as a highly sensitive instrument signaling need for change in public economic policies. It may also serve to restrain expansion in real terms, in view of the heavy dependence of many Western European nations on imports for the resources required for growth in basic industries.

Since even relatively modest price increases may quickly affect the balance of payments of many of these nations, curbing inflation is a more immediately apparent concomitant of economic growth in Western Europe than in the United States. Balance-of-payments considerations, therefore, may require more prompt and vigorous action against inflation than has been the case here. On the other hand, since political stability in Western Europe depends to an appreciable extent on maintaining high rates of employment, the anti-inflationary action required to prevent balance-of-payments difficulties may involve greater political strain than in the United States.

A considerable diversity of policy instruments is employed in Western Europe in seeking national economic objectives. Flexible attitudes concerning expenditure, tax, debt management, and monetary policies appear to be the rule rather than the exception. Recent experience shows repeated instances of substantial changes and modifications in existing policies in quick response to changing economic circumstances.

FISCAL POLICY

On the whole, fiscal policy appears to carry the major burden of public responsibility for providing the conditions requisite for economic growth. To a considerable extent, this follows from the relatively substantial government participation in areas of economic activity which are regarded in the United States as properly the sphere for private activity. The term "public investment" in much of Western Europe, therefore, embraces a substantially wider range of activity than it does in the United States. Because of relatively large government ownership in public utilities, transportation, and communication facilities, and many basic industries, expenditure policies are much more directly involved in the expansion of total productive capacity than is true in the United States.

On the whole, public investment in expansion of the capacity of these industries has been vigorously pursued. Changes in the volume of such outlays, however, show some sensitivity to economic stabilization requirements. For example, during the years 1955–57, generally characterized by rapid increases in private investment outlays and attendant inflationary pressures, cutbacks in public investment were quite generally made. In 1958, when the rate of expansion of gross national product materially slowed, public investment expenditures were increased. Major changes in the volume of public investment programs, however, are not likely, even in the face of substantial economic fluctuations, in view of the basic character of the industries to which such investment is directed.

Tax policies also reflect public concern with promoting a high rate of capital formation. Extensive use is made of liberal depreciation systems, investment allowances, and tax exemptions to stimulate private investment. The relatively heavy statutory rates at which business income is taxed, therefore, are substantially eased by tax devices aimed at encouraging private investment.

As in the case of public investment, these tax encouragements to private investment have been modified at various times in the interest of economic stabilization. In several countries various types of tax restraints were employed to curb the investment boom of 1955–57. Renewed liberalization of the tax treatment of new private investment, though perhaps more moderate than in the immediate post-Korean period, appears to be the present order of the day.

MONETARY AND CREDIT POLICY

Although fiscal policy has been used to a limited extent for stabilization purposes, that is, to compensate for short-run excesses or deficiencies of aggregate demand, primary emphasis has been placed on monetary policy in seeking economic stability. In large part, this reflects the necessary focus of central bank operations on balance-of-payments developments. During the 1955–57 boom period, for example, the vigorously restrictive central bank policies adopted in much of Western Europe had the dual objective of curbing inflationary pressures and of offsetting tendencies toward trade deficits through compensatory short-term capital movements.

Central bank policies do not always reflect congruence of domestic and international trade objectives. In Germany, for example, restrictive monetary policies were employed to curb excessive domestic demand during the 1955–57 boom, despite the increasingly favorable balance-of-payments position Germany enjoyed and the widespread complaints directed against the allegedly excessive strength of the deutschemark. Similarly, the recent recession throughout Western Europe brought some easing of central bank policy, but not to the extent many observers would have deemed desirable on the basis of the conditions of the respective domestic economies. In each such case, the occasion for the conservatism demonstrated by the central bank appears to have been fear of promoting adverse development in the balance-of-payments position by excessive credit liberalization.

The techniques of monetary management by the central banks of Western Europe are highly varied, reflecting the diverse institutional arrangements prevailing in these countries. In some instances, the lack of a highly developed money market has precluded effective use of open-market operations. In others, discount rate variations appear to be of minor significance, since ceilings on bank loans and selective lending practices tend to be the principal instruments of control. Elsewhere, the full array of techniques—open-market operations, changes in reserve requirements, and variations in the discount rate—may be supplemented by more or less formal directives to the commercial banks concerning lending policies.

Capital issues committees, in one form or another, have also been widely employed as a means of controlling the level and character of private investment. These committees are usually comprised of representatives of a number of government departments and representatives of the central bank. Their function, generally, is to screen applications by private enterprises for new security issues in excess of some designated amount. In some cases, the screening process appears to be concerned primarily with the total amount of new issues to be offered on the market, while in others equal emphasis is placed on the character of the investment for which such financing is being sought.

Such committees presuppose the need for some discretionary control by a public agency over private security issues, to limit the level and influence the composition of private investment so as to conform to goals of national economic policy. As such, they suggest reluctance to rely on the free operation of the capital markets to allocate investable resources to their most highly productive channels. The importance of these capital issues committees appears to have been greatly diminished during the recent months of recession, but apparently they were significant instruments in controlling investment demand during the 1955–57 boom.

On the whole, these diverse instruments of monetary and credit control appear to have been used during the 1955–57 boom period quite vigorously. For example, central bank discount rate increases during this period were relatively large and were put into effect over a relatively short period of time. As a corollary, actions to ease credit restraints during 1957–58 were quite pronounced in some instances.

PRICE CONTROLS AND PRICE POLICIES

Throughout western Europe, there is a continuing trend toward deemphasis of price controls. In some cases, direct controls have been entirely eliminated, while in others they have been retained only with respect to a limited list of commodities and services regarded as occupying a strategic place in the economy. On the other hand, government subsidies are still extensively used as a relatively direct means of influencing prices of selected commodities and services, particularly housing.

In several nations, the pricing policies of government-owned enterprises exert an indirect but powerful influence on prices of commodities and services also produced by private firms. Such practices might be expected to distort the structure of relative prices and resource allocation. Except in the case of goods or services not readily available in the world market, however, the availability of alternative sources of supply serves to keep these government pricing policies fairly closely in line with the market.

Without attempting a detailed evaluation of the more or less direct government price controls, it is clear that they do not eliminate the basic factors imposing upward price pressures. In the recent past, for example, the sharp increases in consumer price indexes were attributable to the decontrol of important items in the consumer's market basket. Price controls, quite evidently, had served to defer realization of price increases, not to eliminate the source of pressure.

WAGE POLICIES

Wage policies in several of the Western European countries studied are regarded as important factors in the attainment of economic and price-level stabilization objectives. Such policies reflect the highly diverse institutions and circumstances of these countries. In general, however, implementing these policies appears to have depended largely on the cooperation of organized labor with the government. This cooperation appears to be based on a relatively widespread awareness by labor of (1) the possible adverse effects of rapid increases in wage rates on the nation's foreign trade position, upon which a high proportion of total economic activity depends, and (2) the importance of high levels of investment, not only in terms of the immediate employment opportunities created, but also of the longer run effects on productivity and therefore on living standards. Accordingly, labor appears somewhat more willing than in the United States to accept a stable or even temporarily diminished share in the national income in the interests of channeling a relatively large proportion of available resources into capital accumulation rather than current consumption.

In this connection, it is interesting to note the current concern of some governments and leaders in the labor movement with increasing personal saving propensities. A significant increase in the rate of personal saving presumably would permit expansion of labor's share in the national income without serious effects on the availability and cost of real investable resources.

Consumer prices have risen more rapidly since 1948 in those countries using wage controls than in those in which wage negotiation has been substantially free from government intervention. It is quite possible, of course, that price pressures orginating in rising costs would have been even greater in the former countries in the absence of wage controls. On the face of it, however, the record suggests that government participation in wage determination has not been particularly effective as an anti-inflation weapon.

An apparent qualification of this conclusion arises from the substantial dependence of the countries employing wage controls on imports for basic raw materials as well as consumer goods. An important part of the upward course of the consumer price level in these countries is undoubtedly attributable to the rise in world price for these imports. In these circumstances, wage controls may serve to prevent accentuation of inflationary pressures originating abroad. On the other hand, those countries in which government intervention in wage determination was insignificant were also subject to these price pressures originating in the world market. The fact that the price level in those countries rose, on the whole, no more sharply, indeed in some cases less, than in wage-controlled economies, tends to confirm the conclusion that wage policies have not been a critical factor.

Although explicit data are lacking, several specific instances were cited in which government intervention in wage determination appears to have impeded dynamic adjustments in productive activity and impaired most efficient use of labor services. Government wage policies, to be acceptable in a free country, appear to require a considerable degree of wage and salary standardization. Differentials among firms or industries would obviously give rise to charges of discrimination. On the other hand, the more broadly applicable the wage standards, the greater is the likelihood that inefficient use of labor services will be encouraged and more productive employments frustrated by the inability of the most efficient firms to use wage differentials as a means of attracting a greater share of the labor force.

Coordination of Economic Policies

Particularly impressive, even upon cursory examination, is the close coordination of public economic policies in each of the countries included in the survey. Such coordination does not imply that all policies necessarily move in the same direction or at the same time, nor does it mean, in the case of credit policy, lack of autonomy or subservience of the central bank to the government. Coordination, rather, appears to proceed from appreciation of the specialized capabilities and limitations of the various policy instruments, and from acceptance of the broad outlines of public policy as formulated by the government. Within this frame of reference, disagreements among those responsible for management of the various policy instruments appear to be expected, are quite readily acknowledged, and frequently are helpful in anticipating and preparing for the mutual adjustments which may be required.

In most of Western Europe, balance-of-payments considerations act as an important governor on public economic policies. The economic and price-level stabilization effects of significant policy changes very often can be quickly discerned and evaluated by reference to balance-of-payments developments. Moreover, the central concern over the foreign-trade position tends to require appraisal of policies applicable to widely diverse areas of economic activity against a single standard. Balance-of-payments considerations, therefore, help to integrate and coordinate public economic policies.

As indicated, the response of the nations of Western Europe to the problems of economic development and growth has been quite varied, reflecting diversity of circumstances and historical background. The following discussion is aimed at the highlights in the economic development and policies of the countries to which the four committee members directed their attention.

TABLE 1.—*Selected economic indicators for O.E.E.C. member countries combined, 1948, 1950, 1953–58* [1]

Indicator		1948	1950	1953	1954	1955	1956	1957	1958	Percent increase, 1948–57	Annual rate of growth, 1948–57
Gross national product [2]	Billions of 1954 U.S. dollars.	148.3	172.4	195.7	205.2	218.1	227.5	236.9	[3] 241.0	59.7	5.3
Gross domestic fixed capital formation	do	23.4	28.3	32.6	36.0	39.8	42.4	44.2	[3] 44.9	88.9	7.3
Residential construction	do	(4)	5.5	7.8	8.8	9.2	9.5	9.8	(4)	[5] 78.1	[5] 8.6
Other construction	do	(4)	8.1	8.9	9.5	10.5	11.2	11.8	(4)	[5] 45.7	[5] 5.5
Machinery and equipment	do	(4)	14.6	15.9	17.8	20.2	21.7	22.6	(4)	[5] 54.8	[5] 6.4
Public consumption	do	22.2	24.7	29.8	29.8	29.8	31.5	32.3	[3] 33.4	45.5	4.3
Defense	do	(4)	8.8	12.3	11.7	10.9	11.5	11.6	(4)	[5] 31.8	[5] 3.5
Civil	do	(4)	15.8	17.4	18.1	19.0	19.9	20.8	(4)	[5] 31.6	[5] 3.5
Private consumption	do	105.8	117.6	130.8	136.1	143.8	150.5	156.0	[3] 158.9	47.4	4.4
Real per capita gross national product	1953=100	80	91	100	104	110	113	117	[3] 117	46.2	4.3
Defense as percent of gross national product	Percent	(4)	5.1	6.3	5.7	5.0	5.1	4.9	(4)		
Gross domestic fixed capital formation as percent of gross national product.	do	15.8	16.4	16.7	17.5	18.2	18.6	18.7	18.6		
Residential construction as percent of gross domestic fixed capital formation.	do	(4)	19.4	23.9	24.4	23.1	22.4	22.2	(4)		
Other construction as percent of gross domestic fixed capital formation.	do	(4)	28.6	27.3	26.4	26.4	26.4	26.7	(4)		
Machinery and equipment as percent of gross domestic fixed capital formation.	do	(4)	51.6	48.8	49.4	50.8	51.2	51.1	(4)		
Industrial production	1953=100	69	86	100	109	119	125	131	134	89.9	7.4

NOTE.—This table provides the basic information necessary for obtaining indicators of the development, in terms of both volume and prices of the national product and expenditure of Member countries combined. In using them the limitations to which the data are subject should be borne in mind. First, there are a number of gaps in the original country statistics from which these O.E.E.C. totals were derived, especially for the earlier years of the period. These gaps had to be filled in by the O.E.E.C. Secretariat with estimates which in many cases may be subject to an important margin of error. Secondly, the official exchange rates used to convert European currencies to dollars considerably understate the relative purchasing power of these currencies, and consequently distort seriously the comparison of the levels of real national product and expenditure in Europe with those in the United States. The inadequacies of conversion by exchange rates are much less important, however, for the development over time of the volume and price indices implied in the data, since the choice of the conversion factor here only influences the relative weights assigned to the individual countries in arriving at the average for the O.E.E.C. Member countries.

For a fuller discussion of the significance and limitations of the data presented in these tables, see "Statistics of National Product and Expenditure, No. 2, 1938 and 1947–55," pp. 33–35, published by O.E.E.C.

Adapted from July 1958 O.E.E.C. Statistical Bulletins, General Statistics, p. 99.

[1] 1954 prices and 1954 exchange rates.
[2] At market prices.
[3] Estimate by Secretariat, O.E.E.C.
[4] Not available.
[5] 1950–56.

Source: Organisation for European Economic Co-operation.

ECONOMIC GROWTH COMPARISONS, O.E.E.C. COUNTRIES AND THE UNITED STATES

TABLE 2.—*Annual rates of growth of real gross national product, 1948–57*

[Percent]

Country	1948–50	1950–53	1953–57	1948–57
O.E.E.C. member countries (total)	7.8	4.3	4.9	5.3
Selected countries:				
France	11.1	3.8	5.5	6.1
Germany	(1)	8.7	7.5	[2] 8.0
Italy	6.2	6.0	5.4	5.8
Netherlands	5.6	4.3	5.1	5.0
Sweden	5.8	1.9	4.2	3.8
United Kingdom	3.6	2.0	3.0	2.8
United States	4.3	5.2	2.4	3.7

[1] Not available.
[2] 1950–57.

Source: Organisation for European Economic Co-operation. (See note to table 1.)

TABLE 3.—*Annual rates of growth of per capita real gross national product, 1948–57*

[Percent]

Country	1948–50	1950–53	1953–57	1948–57
O.E.E.C. member countries (total)	6.7	3.2	4.0	4.3
Selected countries:				
France	8.0	3.2	4.7	4.9
Germany	(1)	7.7	6.4	[2] 6.9
Italy	5.1	5.6	4.9	5.1
Netherlands	4.1	3.2	4.0	3.7
Sweden	5.0	1.0	3.6	3.0
United Kingdom	3.3	1.7	2.6	2.5
United States	2.3	3.6	0.7	2.0

[1] Not available.
[2] 1950–57.

Source: Organisation for European Economic Co-operation. (See note to table 1.)

TABLE 4.—*Annual rates of growth of industrial production, 1948–57*

[Percent]

Country	1948–50	1950–53	1953–57	1948–57
O.E.E.C. member countries (total)	11.6	5.2	7.0	7.4
Selected countries:				
France	6.5	4.0	8.6	6.3
Germany	27.9	11.5	10.1	14.4
Italy	12.1	8.6	8.3	9.2
Netherlands	11.4	4.4	5.9	6.6
Sweden	3.9	1.7	5.9	3.4
United Kingdom	7.1	2.1	3.8	3.9
United States	3.8	6.0	1.7	3.6

Source: Organisation for European Economic Co-operation. (See note to table 1.)

TABLE 5.—*Annual rates of growth of real private consumption, 1948–57*

[Percent]

Country	1948–50	1950–53	1953–57	1948–57
O.E.E.C. member countries (total)	5.4	3.6	4.5	4.4
Member countries:				
France	8.1	4.8	5.4	5.8
Germany	(1)	8.7	7.5	[2] 8.0
Italy	6.2	5.6	3.6	4.8
Netherlands	2.2	1.1	5.9	3.5
Sweden	2.6	1.3	3.2	2.4
United Kingdom	2.7	.6	2.7	2.0
United States	4.5	2.7	3.5	3.5

[1] Not available.
[2] 1950–57.

Source: Organisation for European Economic Co-operation. (See note to table 1.)

TABLE 6.—*Annual rates of growth of real gross domestic fixed capital formation, 1948–57*

[Percent]

Country	1948–50	1950–53	1953–57	1948–57
O.E.E.C. member countries (total)	10.0	4.8	7.9	7.3
Selected countries:				
France	5.3	1.2	9.6	5.8
Germany	(1)	8.5	9.7	[2] 9.2
Italy	5.3	9.4	8.6	8.1
Netherlands	6.3	3.2	8.5	6.2
Sweden	4.6	4.4	4.0	4.3
United Kingdom	6.6	3.5	5.7	5.1
United States	5.7	1.5	3.6	3.4

[1] Not available.
[2] 1950–57.

Source: Organisation for European Economic Co-operation. (See note to table 1.)

TABLE 7.—*Real gross domestic fixed capital formation as a percent of real gross national product, 1948–57*

Country	1948–50	1951–53	1954–57	1948–57
O.E.E.C. member countries	16.1	16.3	18.3	17.2
Selected countries:				
France	17.4	15.8	17.1	16.8
Germany	(1)	18.9	21.8	[2] 20.7
Italy	17.3	18.6	20.7	19.2
Netherlands	21.1	19.6	22.6	21.4
Sweden	18.2	18.7	19.9	19.1
United Kingdom	12.7	13.1	14.6	13.7
United States	16.1	15.8	16.5	16.4

[1] Not available.
[2] 1950–57.

Source: Organisation for European Economic Co-operation. (See note to table 1.)

TABLE 8.—*Annual rates of increase of consumer prices, 1948–57*

[Percent]

Country	1948–50	1950–53	1953–57	1948–57
O.E.E.C. member countries:				
France	[1] 11.2	8.9	1.2	[2] 5.3
Germany	−3.4	2.4	1.7	.8
Italy	.1	5.2	3.1	3.1
Netherlands	[1] 8.6	4.3	4.7	[2] 5.0
Sweden	1.3	8.1	3.3	4.5
United Kingdom	2.6	7.2	3.8	4.7
United States	0	3.6	1.3	1.8

[1] 1949–50.
[2] 1949–57.

Source: Organisation for European Economic Co-operation.

TABLE 9.—*Rates of unemployment, 1948–57*

[Percent]

Country	1948–50	1951–53	1954–57	1948–57
O.E.E.C. member countries:				
Selected countries:				
France [1]	1.6	1.8	1.6	1.7
Germany [2]	7.8	8.2	4.8	6.6
Italy	(3)	(3)	(3)	(3)
Netherlands [4]	2.1	3.9	1.9	2.6
Sweden [5]	2.6	2.3	2.7	2.6
United Kingdom [6]	1.6	1.5	1.3	1.5
United States [7]	5.0	3.1	4.6	4.3

[1] Applicants for work as percent of nonagricultural employment plus applicants for work.
[2] Registered unemployment as percent of total employees plus registered unemployed.
[3] Not available.
[4] Registered unemployment as percent of total nonagricultural employment plus registered unemployment. Nonagricultural employment estimated after 1953.
[5] Unemployed members of trade unions as percent of all members.
[6] Wholly unemployed as percent of estimated number of insured employees.
[7] Unemployed as percent of civilian labor force.

Sources: Organisation for European Economic Co-operation (see note to table 1); U.S. Department of Commerce.

II

INDIVIDUAL COUNTRIES

FRANCE

I. Economic Development Since 1948

The record of the French economy since 1948 is characterized both by vigorous growth in real gross national product and by pronounced and persistent inflationary price developments.

Total economic activity in France responded dramatically to Marshall plan aid and loans: gross national product in constant prices increased by 11 percent a year in 1949 and 1950. Between 1950 and 1953, real gross national product grew at an average annual rate of slightly more than 3¾ percent, and increased more rapidly thereafter, at about 5½ percent annually into 1957. Moreover, unemployment throughout much of this period has been extremely low. Up to the present it has been impossible to adjust French unemployment data for comparability with those of the United States. Apart from the relatively substantial manpower demands arising from military and defense activities, an important factor in limiting unemployment appears to have been a tendency by business to hoard labor against prospective future demands. Average weekly hours of work is accordingly regarded as a more sensitive and informative economic indicator than unemployment ratios.

Capital formation has proceeded at a high rate over much of the period since 1948. Gross domestic fixed capital formation has increased since 1948 at an annual rate averaging 5.8 percent, and has averaged about 17 percent of gross national product, slightly below the average for Western Europe as a whole. A relatively large proportion of French investment has been directed toward construction, as compared with the greater emphasis on machinery and equipment reflected in data for Western Europe as a whole. Apparently, relatively heavy military and defense demands and a rapid rise in real private consumption experienced in France since 1948 have not materialy impeded expansion of productive capacity.

The rise in the cost of living since 1948 has been more substantial in France than in virtually any other nation in Western Europe. Consumer prices increased at an average annual rate of 5.3 percent between 1949 and 1957. In considerable part, major movements in the consumer price index have represented release of price pressures upon removal or relaxation of price controls or reductions in subsidies. When price controls on a wide variety of items were relaxed in 1949, in favor of more or less general fiscal and monetary restraints, prices spurted over 11 percent (7.8 percentage points in the index). Along with increasing reliance on general fiscal and monetary measures aimed at closing the inflationary gap, reintroduction of selective price controls and subsidies to producers, particularly in agriculture, brought a measure of price-level stability in the years 1953 through 1956. During this period consumer prices rose at a rate of less than 1 percent a year. Since mid-1957 progressive elimination of controls has resulted in sharp selective price increases, reflected in a 16-percent increase in the index of consumer prices between 1957 and 1958.

II. Public Economic Policies

A. POLICY FOCUS

From the end of World War II until the early 1950's, the major focus of French public policy was, as might be expected, on economic reconstruction. Expansion of energy sources and basic industry were accorded top priority under the first plan selected by the economic planning agency, the Commissariat du Plan, and substantial public expenditures were made in these lines. The use of direct price controls and subsidies also served to mobilize resources to serve this objective.

Emphasis shifted in 1954 from reconstruction to expansion with the adoption of the second modernization and equipment plan. Without reducing the level of investment in basic industries, this plan sought to promote higher rates of private capital accumulation in an increasing number of sectors of the economy. With the expanding role of private investment, currency stabilization and improvements in the foreign trade position were given greater emphasis.

Through much of the postwar period, French public economic policies have been affected to a relatively more substantial extent than those of other Western European nations by military and defense demands. The draining off of resources to meet these demands has undoubtedly complicated the problem of providing rising living standards and monetary stability.

B. ECONOMIC PLANNING

The Commissariat du Plan (General Planning Commission) was established in 1946, presumably with responsibility for formulating and directing Government economic policies. Although the Commissariat works closely with various Government ministries, its authority to plan economic activity in fact appears to be negligible. Its principal function appears rather to be evaluating probable economic developments and recommending fiscal, monetary, and other policy measures deemed appropriate to the realization of economic policy objectives. In this role, the plan apparently functions more as an instrumentality for coordinating public policies than as an agency for directing the allocation of resources.

The principal concern of the Commissariat du Plan is with expansion of productive capacity and of total economic activity. Responsibility for control of inflation rests primarily in the Bank of France. In its recommendations, however, the plan is guided by the probable impact of the pace and character of the expansion programs it contemplates upon the conditions for price-level stability. Accordingly, these recommendations are likely to be presented in global terms and to include recommendations concerning tax, expenditure, and credit policies which would most closely conform with objectives of growth, employment, and price-level stability.

C. FISCAL POLICY FOR ECONOMIC GROWTH

Since a substantial portion, perhaps 20 percent, of French industry is government-owned, public expenditure policies are to a substantial extent directly concerned with expansion of productive capacity. Since the end of the war, budget deficits have been the rule, although a large proportion of long-range expenditure programs have apparently been financed by long-run borrowing, rather than by expansion of bank credit. At least in terms of recommendations by the Commissariat du Plan, balance is sought between total capital expenditures, public and private, and total savings, public and private, rather than between budget receipts and expenditures. To the extent that private investment programs exceed the expectations taken into account in formulating budget programs, all other things being equal, inflationary pressures will be generated. Central bank policy appears to be somewhat more closely oriented to accommodating financial demands arising from total investment activity, even though the resulting credit expansion may prove excessive, than to keeping total credit expansion in line with considerations of general price stability. In contrast with Italy, where government ownership is also reflected in relatively high levels of public investment and where a more vigorously anti-inflationary credit policy appears to have limited private investment relative to total capital outlays, monetary policy in France seems to have permitted a somewhat greater private share in total investment, financed in part by periodic inflationary thrusts.

Tax policy reflects emphasis on economic growth. In addition to a progressive income tax with steeply graduated rates in the low- and middle-income brackets, a value-added tax and a tax on services are imposed at rates ranging from 10 to 27.5 percent. The local tax is assesed on all sales not subject to either the value-added or services tax, at rates from 2.2 to 8.5 percent. In addition, numerous specific indirect taxes are levied. The cumulation of these taxes imposes a substantial tax load on consumption.

Although corporate profits are subject to tax at 50 percent, the effective tax burden may be reduced by several provisions aimed at stimulating capital outlays. One grants a full year's depreciation allowance, in addition to that normally granted, on a new piece of equipment in the year of acquisition. This additional allowance is not available for assets with useful lives of less than 5 years or for buildings. Moreover, an additional deduction of 10 percent is allowed in the taxable year in which the equipment is acquired on certain specified types of equipment acquired for modernization of production facilities. In addition, a deduction from taxable income is allowed with respect to dividends paid on new shares issued to increase paid-in capital, or in the case of new companies, to the holders of the shares corresponding to the total initial paid-in capital. The deduction is limited to 5 percent of the new capital. In the case of existing companies, the deduction may be claimed in each of the first 7 taxable years following the increase in capitalization, and in the case of new firms, in the 4th through 10th taxable years following establishment. A further provision reduces the base for imposition of the value-added tax on new construction by 39 percent.

D. STABILIZATION POLICY

1. Monetary and credit controls

Principal responsibility for stabilizing rates of employment and the price level rests with monetary and credit instruments in French public policies. The National Credit Council, consisting of representatives of the Government and of various economic and financial interests, sets the broad lines of monetary and credit policy. Within this policy framework, the Bank of France, nationalized since 1946, has considerable autonomy and makes the important decisions governing the day-to-day operations of the central bank.

The bank's credit-control measures include changes in the discount rate, upon which major reliance is placed, control of minimum reserves to be held by banks in the form of Treasury issues, open-market operations, and certain measures of qualitative control.

Presumably, the effectiveness of the stabilizing actions by the Bank of France depend in part on the broad monetary policy framework established by the National Credit Council and the accuracy of the estimates concerning the availability of savings to finance projected investment programs, which influence credit policy formulation. The latitude of responsibility by the bank in forecasting the extent to which credit demands may be met without inflationary consequences and in acting upon such estimates is restricted to some extent by the activities of other credit institutions with responsibility for passing on credit applications. For example, all security issues in excess of $200,000 require approval by a capital issues committee, on which the Commissariat du Plan, the Ministries of Finance, Economic Affairs, and Industry, and the bank are represented. This committee exerts considerable influence on both the volume of money-market demands and the character of the investment program for which financing is sought. In addition, a number of other credit and banking institutions have similar power over intermediate term borrowings. Bank of France decisions affecting general credit conditions, therefore, are subject to considerable qualification by more specific direction and control, exercised by other agencies, of investment projects requiring external financing.

2. Prices and price controls

The role of direct controls over prices has changed markedly in French economic policies since the end of World War II. Until 1949 these controls represented the principal public instrument for containing inflationary price pressures. Early in 1949, however, it was recognized that this system had failed to attack the sources of inflationary developments and could, in fact, curb general price increases only at the expense of restricting output and expansion of capacity. Emphasis was shifted, therefore, to closing the inflationary gap through fiscal and monetary measures. Price controls and subsidies were subsequently reintroduced, but as supplements to, rather than substitutes for, general curbs.

From mid-1957, progressive dismantling of the price-control structure has been undertaken. Most consumer durables are now free of controls and other items are in process of decontrol.

On the other hand, a fairly elaborate system of price supports has been developed recently for a wide variety of agricultural products. The objective of these target prices is to provide strong price incentives for increasing agricultural output, particularly of those items which are important components of French exports. It is recognized that these price developments may raise serious obstacles in freeing nonagricultural prices from controls in view of the possible cumulative impact on living costs. On the other hand, it is hoped that these increases in raw material costs may have the beneficial side effect of spurring agricultural-product processing industries to modernization and increasing efficiency, since the obsolescence of these industries has apparently contributed extensively to high retail prices.

Wage policy in the postwar period has been aimed primarily at setting wage floors rather than ceilings. Some curb on wage rate increases, however, is effected through the Government policy of undertaking renegotiation of procurement contracts with private businesses only if cost increases have been kept within prescribed limitations.

Another potentially powerful restraint on wages stems from the fact that the French Government is the largest single employer in the economy, its payrolls of civil servants and employees of nationalized enterprises accounting for about one-fourth of the nonagricultural labor force. Government wage policy, therefore, can exert a powerful influence on the pattern of wage settlements throughout the economy.

TABLE 10.—*Selected economic indicators for France, 1948, 1950, 1953–58*

Indicator		1948	1950	1953	1954	1955	1956	1957	1958	Percent increase, 1948–57	Annual rate of growth, 1948–57
Gross national product [1]	Billions of 1954 French francs.	10,900	13,461	15,040	15,710	16,672	17,554	18,629	[2] 19,100	70.9	6.1
Gross domestic fixed capital formation	do	[2] 2,000	2,218	2,302	2,514	2,843	3,066	3,328	(3)	66.4	5.8
Residential and other construction	do	(3)	[2] 1,190	(3)	1,385	1,544	1,593	1,740	(3)	[4] 46.2	[4] 5.5
Machinery and equipment	do	(3)	[2] 1,030	(3)	1,129	1,299	1,473	1,588	(3)	[4] 54.2	[4] 6.4
Public consumption	do	1,500	1,920	2,358	2,174	2,124	2,544	2,700	(3)	80.0	6.8
Defense	do	500	(3)	1,211	1,003	857	1,182	1,278	(3)	155.6	11.0
Civil	do	1,000	(3)	1,147	1,171	1,267	1,362	1,422	(3)	42.2	4.0
Private consumption	do	7,700	8,995	10,360	10,717	11,353	12,077	12,778	(3)	65.9	5.8
Real per capita gross national product	1953=100	[2] 78	91	100	104	109	114	120	[2] 122	53.8	4.9
Defense as percent of gross national product	Percent	(3)	(3)	8.1	6.4	5.1	6.7	6.9	(3)	----------	----------
Gross domestic fixed capital formation as percent of gross national product.	do	(3)	16.5	15.3	16.0	17.1	17.5	17.9	(3)	----------	----------
Residential and other construction as percent of gross domestic fixed capital formation.	do	(3)	53.7	(3)	55.1	54.3	52.0	52.3	(3)	----------	----------
Machinery and equipment as percent of gross domestic fixed capital formation.	do	(3)	46.4	(3)	44.9	45.7	48.0	47.7	(3)	----------	----------
Industrial production [5]	1953=100	80	89	100	109	117	128	139	147	73.8	6.3
Unemployment rate [6]	Percent	1.1	2.0	2.3	2.3	2.0	1.4	1.0	[7] 1.1	----------	----------
Hourly wage rate [8]	1953=100	53	66	100	106	114	123	132	[9] 148	149.1	10.7
Consumer prices	do	[10] 69.6	77.4	100	99.7	100.8	102.8	[11] 104.9	121.6	[12] 50.7	[12] 5.3
Wholesale prices [13]	do	[10] 72.3	78.3	100	98.3	98.1	102.6	108.2	120.7	[12] 49.7	[12] 5.2

[1] At market prices. (The French national accounts have been revised from 1949 to date. Data prior to 1949 are in process of being revised.)
[2] Estimate by Secretariat, O.E.E.C.
[3] Not available.
[4] 1950–57.
[5] Annual figures which cover 22 branches of industrial activity are not the average of monthly or quarterly data which cover 19 branches.
[6] Applicants for work as percent of nonagricultural employment plus applicants for work.
[7] 1st 3 quarters.
[8] In manufacturing.
[9] Average of 1st 2 quarters.
[10] For 1949.
[11] Beginning July 1957, July 1956–June 1957=100.
[12] 1949–57.
[13] Basic materials and semimanufactured products only.

Source: Organisation for European Economic Co-operation. (See note to table 1.)

GERMANY

I. Economic Development Since 1948

Substantial expansion of total economic activity and productive capacity, rising levels of consumption, steady improvement in employment conditions, and relative stability in consumer prices are the outstanding features of economic development in West Germany since 1948. The burst of activity that followed the reorganization of the German economy and the currency stabilization of 1948 resulted in a sharp increase in industrial production. The index rose 63 percent between 1948 and 1949 and 39 percent between 1949 and 1950. For the entire period since 1948, industrial production has increased at an average annual rate of 14.4 percent. Although the rate of expansion of industrial output slowed appreciably after 1950, the average annual increase of over 10 percent since 1950 is substantially above the average for OEEC countries combined,

Underlying this rapid rise in industrial production has been a high rate of fixed capital formation. Since 1950, gross domestic fixed capital formation has represented one-fifth or more of gross national product, and has expanded at an annual rate of 9.2 percent. Nearly half of these capital outlays have been in residential construction.

Gross national product in 1954 prices increased by 72 percent between 1950 and 1957. The average annual increase during this period was 8 percent; on a per capita basis, real gross national product increased by close to 7 percent annually.

Despite the heavy emphasis on capital formation, real private consumption has risen more rapidly in Germany since 1950 than in any of the other countries included in this survey and at almost twice the average rate for all OEEC countries. Consumer prices, which were 93 percent of the 1953 average in 1950, reached 107 percent in 1957. Since 1948, the average increase has been less than 1 percent per year. Unemployment has been steadily reduced, from slightly more than 10 percent of the labor force in 1950 to about 3½ percent in 1957 and 1958. Average hourly earnings in manufacturing and building have more than doubled since 1948, increasing at an average annual rate of 8.2 percent.

Although Germany has a trade deficit with the dollar area, it has maintained a substantial export surplus with other currency areas. The volume of German foreign trade has risen to the point that the Federal Republic is now the third most important trading country in the world. In 1958, German exports and imports were valued at $16.2 billion as compared with $4.7 billion in 1950. As a result of the German export surplus, gold and foreign exchange balances have risen steadily and amounted to $6.3 billion at the end of 1958, of which $4.6 billion was in gold and dollars.

The Western European recession in 1958 was reflected in Germany in a slowing rate of expansion rather than in a downturn in the level of economic activity. Over the next several years, the gross national product will probably continue its present more modest growth trend, even though a high level of economic activity may be assumed. Factors limiting such growth are expected to come mainly from the resources, rather than the demand side.

II. Public Economic Policies

A. POLICY FOCUS

On the basis of the statistical record, no categorical assertion is possible with respect to the priorities accorded economic growth, high levels of employment, and price-level stability as objectives of public economic policy in West Germany. Actually, the substantial progress recorded in achieving each of these objectives is, at least in part, a function of the flexibility of public economic policies and alertness to changing economic conditions and policy requirements.

In general, the condition of the German economy following World War II dictated substantial emphasis on capital accumulation, at first for reconstruction and subsequently for expansion of productive capacity. The great importance attached to price-level stability reflects not only the balance-of-payments considerations important in any open economy, but also the sharp reaction of the people to the hyperinflations experienced in Germany following World Wars I and II. During the period of relatively great slack in resource use following World War II, pressures on the price level from the cost side were relatively modest. As employment conditions improved and expanding demand reached boom proportions, vigorous credit restraints were employed to arrest inflationary pressures, with recognition that such restraints, to the extent they were effective, might well serve to damp down economic growth. By the same token, when a slowing rate of expansion of economic activity and therefore abatement of inflationary strain from the demand side became evident, monetary and credit restraints were promptly eased. As summarized by one West German Government official, public economic policies emphasize price-level stability under conditions of full employment and improvement of employment conditions in recessionary situations. As reflected in overall policies, a rapid rate of expansion of productive capacity has claimed a high priority throughout.

B. PROMOTING ECONOMIC GROWTH AND PRICE-LEVEL STABILITY

As in much of the rest of Western Europe, principal responsibility in West German public policies for encouraging economic growth rests on fiscal devices. Close to one-fifth of Central Government expenditures are devoted to civil construction and housing and economic promotion. The tax structure is heavily weighted against consumer outlays. Turnover and other consumption taxes plus import duties account for close to three-fifths of budget revenues; the individual income tax imposes relatively heavy tax burdens at the lower and middle range of the income distribution, while numerous tax preferences are accorded for approved forms of savings and for various classes of business income.

Experience since 1948 reflects a good deal of flexibility and lack of inhibition in using tax devices to stimulate various types of capital outlays as part of an extensive, long-range program to expand the Nation's industrial base. A variety of special accelerated depreciation allowances have been used for this purpose, particularly in the period 1948–52, when straight-line depreciation was the normal method for tax purposes. The declining-balance method was made widely available in 1952 in view of the prevailing weakness in the capital markets and the consequent need for internal financing of business enterprises and the rapid obsolesence of depreciable facilities. In 1958, recognition of certain undesirable aspects of too extensive reliance on internal financing resulted in a cutback in depreciation rates, although the declining-balance method of depreciation was made available to classes of assets not included in the general extension in 1952. Encouragement of liberal dividend policies and therefore reliance on external sources of funds is also afforded by the fact that the flat 30 percent tax rate on corporate profits is reduced to 15 percent on the part of the corporation's taxable income distributed as dividends. The result, apparent by the end of 1958, has been the development of a dynamic capital market.

The division of labor in West German public policy between fiscal and monetary devices follows along much the same lines as in most of Western Europe. Fiscal policy appears to emphasize long-term aspects of expansion of economic capacity and of high employment opportunities, while monetary policy is invested with primary responsibility for price-level stability and for confining short-run fluctuations in levels of economic activity to moderate proportions.

In the period 1953–58, central bank policy in Western Germany apparently contributed significantly to moderating both the investment boom during the first 4 years and the incipient recessionary forces during the latter 2. Credit restraint took the form, primarily, of sharp increases in the rediscount rate, from 3 percent to 5.5 percent over a very few months, i. e., between August 1955 and May 1956. The abruptness of this credit-tightening drive was coupled with a substantial transfer of reserves from the commercial banks to the central bank as a result of a budget surplus, required by law to be held in the central bank, which emerged from a slower rate of expansion of Government expenditures than had been anticipated. Vigorous open-market operations were also employed. Credit easing was begun in the early fall of 1956, primarily through lowering of the rediscount rate, which by June 1958 had returned to the 3 percent level. Easing of credit restraints was undertaken even in the face of rising prices, in part because of the rapid rise in the balance-of-payments surplus, particularly on capital account. In addition, a material slowing in the rate of expansion of economic activity was noted by the central bank authorities, who counted on increasing productive capacity to exert a significant curb on inflationary pressures. The disinclination on the part of the central bank to gear its policies exclusively to movements of the consumer price index is also evidenced by efforts to reduce long-term interest rates. Considerable success in this regard has been achieved during the past year or so with a reduction in the structure of these rates from an average of around 8 or 9 percent to 6 percent.

Credit easing from 1956 apparently resulted in an expansion of small business demand for plant and equipment, which served to prevent marked decline in orders for machinery when the investment boom tapered off. The reduction of rates in the long end of the capital market apparently contributed to this result.

The autonomy of the central bank appears to have been clearly established by developments during the past decade. While there is widespread recognition of the specialization of economic policy functions, as noted above, central bank policies on the whole appear to have been determined within the context of broad public economic policy objectives. The continuing emphasis in fiscal policy on expansion of productive capacity finds its counterpart in central bank efforts to reduce the long-term interest rate structure and in the willingness of the bank to shift promptly from credit restraint to ease at signs of flagging investment demand.

Other factors besides fiscal and monetary policies have apparently contributed to the relatively high degree of stability of the price level in Western Germany. The rapid expansion of fixed capital has resulted in a steady and strong upward movement in productivity, which has made possible a relatively rapid increase in wage rates since 1954 without increasing unit labor costs. Moreover, the post-1948 German investment program was considerably enhanced by opportunities for capitalizing on technological advances made elsewhere. Real capital costs accordingly have been held in check. Efforts at freezing external trade relations have served to provide substantial opportunities for savings on imports.

There are some grounds for anticipating that the labor share of national income, which remained relatively stable and relatively low over much of the period since 1948, will expand in 1959 and following years. The constraints which this development might be expected to exert on capital accumulation may very well be mitigated by the marked rise in personal savings observable in the past year or two.[1]

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[1] See p. 7, above.

TABLE 11.—*Selected economic indicators for Germany, 1948, 1950, 1953–58*

Indicator		1948	1950	1953	1954	1955	1956	1957	1958	Percent increase, 1948–57	Annual rate of growth, 1948–57
Gross national product [1]	Million of 1954 deutsche marks.	(2)	111,800	143,800	153,950	172,100	183,050	192,250	[5] 198,400	[3] 72.0	[3] 8.0
Gross domestic fixed capital formation	do	(2)	22,200	28,400	32,205	38,200	41,020	41,130	(2)	[3] 85.3	[3] 9.2
Residential and other construction	do	(2)	10,870	14,020	15,245	17,365	18,720	18,660	(2)	[3] 71.7	[3] 8.0
Machinery and equipment	do	(2)	11,330	14,380	16,960	20,835	22,300	22,270	(2)	[3] 96.6	[3] 10.0
Public consumption	do	(2)	18,050	21,750	22,350	22,850	23,080	24,660	(2)	[3] 36.6	[3] 4.6
Defense	do	(2)	[5] 5,509	[5] 6,429	[5] 5,950	[5] 5,770	[5] 4,848	[5] 5,593	(2)	[3] 1.5	[3] .2
Civil	do	(2)	[5] 12,541	[5] 15,321	[5] 16,400	[5] 17,080	[5] 18,232	[5] 19,067	(2)	[3] 52.0	[3] 6.2
Private consumption		(2)	67,030	86,170	92,328	101,050	109,890	114,930	(2)	[3] 71.5	[3] 8.0
Real per capita gross national product	1953=100	(2)	80.0	100.0	106.0	117.0	123.0	128.0	130.0	[3] 60.0	[3] 6.9
Defense as percent of gross national product	Percent	(2)	4.9	4.5	3.9	3.4	2.6	2.9	(2)	----------	----------
Gross domestic fixed capital formation as percent of gross national product.	do	(2)	19.9	19.7	20.9	22.2	22.4	21.4	(2)	----------	----------
Residential and other construction as percent of gross domestic fixed capital formation	do	(2)	49.0	49.4	47.3	45.5	45.6	45.9	(2)	----------	----------
Machinery and equipment as percent of gross domestic fixed capital formation	do	(2)	51.0	50.6	52.7	54.5	54.4	54.1	(2)	----------	----------
Industrial production	1953=100	44	72	100	112	129	139	147	152	234.1	14.4
Unemployment rate [7]	Percent	[8] 9.0	10.3	7.5	7.0	5.1	4.2	3.5	[9] 3.4	----------	----------
Hourly earnings [10]	1953=100	64	78	100	103	109	119	131	[4] 140	104.7	8.2
Consumer prices	do	[6] 100	93	100	100	102	105	107	110	7.0	.8
Wholesale prices	do	[6] 90	85	100	98	101	103	105	106	16.7	1.7

[1] At market prices.
[2] Not available.
[3] 1950–57.
[4] Average of 4 quarters.
[5] Estimate by Secretariat, O.E.E.C.
[6] July–December.
[7] Registered unemployed as percent of total employees (employed and unemployed).
[8] For 1949.
[9] 1st 10 months.
[10] Manufacturing and building.

Source: Organisation for European Economic Co-operation. (See note to table 1.)

ITALY

I. Economic Development Since 1948

On the whole, Italy's economic record since 1948 is impressive. For the period as a whole, gross national product has increased at an annual rate of close to 6 percent per annum. Real GNP per capita has increased at an annual rate of slightly over 5 percent, while real private consumption has expanded at an average rate of slightly less than 5 percent. Gross domestic capital formation in constant prices has expanded at about 8 percent a year. Industrial production has grown by over 9 percent annually, on the average, since 1948. The cost of living index, through 1957, has increased at an average annual rate of about 3 percent. (A more pronounced rise in early 1958 was attributed to the rise in food prices, resulting from adverse weather conditions, and in rentals, resulting from the removal of controls.) Wholesale prices have remained extremely steady, averaging only 1 percent above the 1953 level during the first several months of 1958 While the growth in employment has been strong, unemployment has remained extremely high—around 10 percent.

The 1957–58 recession in Italy took the form of a substantial slowing of the rate of expansion of gross national product and industrial production, but without any decline in the absolute level of economic activity. It was estimated that by the end of 1958 or early in 1959, economic activity would again be growing at about the prerecession rate. Little influence is attributed to the United States recession; the slowing rate of expansion of production in Western Europe as a whole appears to have been of more immediate consequence for recent economic developments in Italy.

Italy's long-term economic prospects appear, on the whole, quite favorable. Opportunities for economic development are abundant. Industrial development of the southern regions, with attendant requirements for expansion of fuel and energy resources and improvements in transportation, indicates prolonged continuation of high levels of investment demand. On the other hand, substantial resource problems must be overcome. The lack of domestic sources of a wide range of industrial raw materials, the low productivity of a substantial proportion of agricultural labor, particularly in the South, as a result of too small a scale of farm operation, and numerous institutional barriers to expeditious resource reallocations are among the principal difficulties to be faced.

II. Public Economic Policies

A. POLICY FOCUS

As in most of Western Europe, the principal objective of public economic policy in Italy since 1948 appears to have been to achieve and maintain a high rate of economic growth and development. Because of Italy's great dependence on international markets, both for raw materials and for exports, the stability of the lira has been regarded as a primary requisite to facilitate expansion of domestic productive capacity. Curbing inflation, therefore, is closely associated with economic growth as a policy objective.

B. FISCAL POLICY DIRECTED TOWARD ECONOMIC DEVELOPMENT

Substantial segments of Italian industry are in whole or in part Government owned. The emphasis in economic policy on expansion of productive capacity is reflected, therefore, in a large volume of public investment, which, in turn, has resulted in substantial budget deficits. These have been steadily diminishing in recent years. Moreover, since 1952 the bulk of the deficits has been financed by bond issues in the money market, with very limited recourse to direct financing by the bank of issue. Accordingly, public investment has competed with private investment for available savings and credit resources. Although private investment has grown with the expansion of total economic activity, the close control by the central bank over the credit supply has probably served to limit private investment relative to total investment outlays.

Tax concessions, particularly for foreign investment, have also been employed to stimulate investment in selected areas of economic activity. Among the principal tax devices are (*a*) a 50 percent reduction in the transactions tax on materials and machinery acquired in connection with new facilities installations or for the restoration, enlargement, improvement, etc., of existing industrial plants; (*b*) income tax exemptions for 10 years with respect to the income of new industrial plants established before January 27, 1959; (*c*) income tax exemption with respect to increases in income resulting from enlargement, transformation, modernization, or restoration of industrial plants; and (*d*) in the case of companies whose income tax liabilities are assessed on the basis of balance sheets up to 50-percent exemption of profits committed to investment in southern and insular Italy. Specific exemptions for customs duties, registry taxes, mortgage taxes, and regional taxes are also available with respect to investment in new plant and equipment or modernization or conversion of existing productive facilities.

C. MONETARY AND CREDIT POLICIES FOR PRICE-LEVEL STABILITY

While fiscal policy has been primarily oriented to long-range economic development, monetary policy has carried the brunt of the burden in curbing inflationary tendencies.

Principal use has been made of relatively direct credit controls. The characteristics of the Italian money market are such as to preclude effective use of open-market operations and to limit the effectiveness of discount policy. Public ownership of commercial banks permits more direct control of both the volume and the character of bank lending. Reserve requirements may also be changed as an instrument for controlling the availability of credit.

In addition, the Interministerial Committee on Credit acts as a capital-issues committee, screening applications for new security issues. Such applications must be made with respect to any financing in excess of 500 million lire. The principal concern of the committee is in controlling the total volume of such issues, rather than the character of the investment for which financing is sought.

Italian success, such as it has been, in curbing inflationary pressures reflects not only the effectiveness of monetary and credit policies, but also certain basic features of the Italian economy not necessarily found elsewhere. In the first place, a substantial volume of chronic unemployment has prevented wages from rising at unduly rapid rates. Over the 10-year period since 1948, unit wage costs have been relatively steady. Public concern with wage-rate developments, therefore, has been quite limited.

An important factor in wage developments is the highly centralized bargaining procedure. A substantial proportion of wage contracts involving private employers is negotiated by Confindustria, an organization representing most of Italian business outside the public sector. Until recently, Confidustria also had responsibility for negotiating wage settlements with employees in public enterprises. Although such negotiations are now outside Confidustria's jurisdiction, Government enterprise wage patterns conform with those effected in the private sectors. This centralization of wage negotiation is credited with providing uniformity in wage settlements and in minimizing competition among unions to attain differentially favorable contracts.

Capital goods costs have remained quite stable, while quality has improved. The progressive liberalization of foreign trade has contributed to this development by expanding the sources of supply and, by exposing them to foreign competition, spurring Italian business to increasing efficiency. Moreover, relaxation of Government controls on imports has served to increase the flexibility of Italian firms in acquiring raw materials. In view of the extensive dependence of the Italian economy on foreign sources for industrial raw materials, this flexibility has been an important factor in keeping the cost of material inputs in check. Inflation control, therefore, has not had to cope extensively with a rising cost structure.

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TABLE 12.—*Selected economic indicators for Italy, 1948, 1950, 1953–58*

Indicator		1948	1950	1953	1954	1955	1956	1957	1958	Percent increase, 1948–57	Annual rate of growth, 1948–57
Gross national product [1]	Billions of 1954 lire	8,808	9,957	11,876	12,469	13,310	13,866	14,669	[4] 15,000	66.5	5.8
Gross domestic fixed capital formation	do	1,559	1,729	2,265	2,454	2,706	2,927	3,148	(2)	101.9	8.1
Residential construction	do	(2)	288	483	579	701	789	854	(2)	[3] 196.5	[3] 16.8
Other construction	do	(2)	215	356	348	348	312	329	(2)	[3] 53.0	[3] 6.2
Machinery and equipment	do	(2)	1,226	1,426	1,527	1,657	1,826	1,965	(2)	[3] 60.3	[3] 7.0
Public consumption	do	1,076	985	1,291	1,415	1,448	1,520	1,555	(2)	44.5	4.2
Defense	do	[4] 343	[4] 409	[4] 482	[4] 543	[4] 514	[4] 512	(2)	(2)	[5] 49.3	[5] 5.1
Civil	do	[4] 733	[4] 576	[4] 809	[4] 872	[4] 934	[4] 1,008	(2)	(2)	[5] 37.5	[5] 4.1
Private consumption	do	6,422	7,243	8,530	8,713	9,049	9,432	9,831	(2)	53.1	4.8
Real per capita gross national product	1953=100	77	85	100	104	111	115	121	125	57.1	5.1
Defense as percent of gross national product	Percent	3.9	4.1	4.1	4.4	3.9	3.7	(2)	(2)	----------	----------
Gross domestic fixed capital formation as percent of gross national product.	do	17.7	17.4	19.1	19.7	20.3	21.1	21.5	(2)	----------	----------
Residential construction as percent of gross domestic fixed capital formation.	do	(2)	16.7	21.3	23.6	25.9	27.0	27.1	(2)	----------	----------
Other construction as percent of gross domestic fixed capital formation.	do	(2)	12.4	15.7	14.2	12.9	10.7	10.5	(2)	----------	----------
Machinery and equipment as percent of gross domestic fixed capital formation.	do	(2)	70.9	63.0	62.2	61.2	62.4	62.4	(2)	----------	----------
Industrial production	1953=100	62	78	100	109	119	128	138	141	122.6	9.2
Unemployment rate	Percent	(2)	(2)	(2)	(2)	(2)	(2)	(2)	(2)	----------	----------
Hourly earnings [6]	1953=100	79	85	100	104	110	117	123	[8] 128	55.7	5.0
Consumer prices	do	85.7	85.8	100.0	102.7	105.6	110.8	113.0	118.4	31.9	3.1
Wholesale prices [7]	do	104	93	100	99	100	102	103	101	−1.0	----------

[1] At market prices.
[2] Not available.
[3] 1950–57.
[4] Estimate by Secretariat, O.E.E.C.
[5] 1948–56.
[6] In industry.
[7] Revised series after 1950.
[8] Average of 1st 2 quarters.

Source: Organisation for European Economic Co-operation. (See note to table 1.)

THE NETHERLANDS

I. Economic Development Since 1948

The overall economic record of the Netherlands compares favorably with that of Western Europe as a whole. Reflecting the stimulus and opportunities provided by Marshall plan aid and loans, gross national product in the Netherlands rose, in constant prices, at about 5½ percent a year between 1948 and 1950. Following a lull in the early 1950's, real gross national product has been rising since 1952 at about 5 percent annually, slightly above the continental average. The Dutch estimate that a minimum annual increase of 4.5 percent is necessary if standards of living are to be improved at a politically acceptable rate for a population increasing by 1.25 percent a year.

Net investment has been maintained at a high proportion of net national income at 20 percent or better and exceeding 22 percent in recent years. The Dutch regard 20 percent of national income as essential in order to meet both public investment requirements, including housing, and the expansion and improvement of industry.

Employment has been sustained at a very high rate, keeping pace with the steady growth of the labor force. Unemployment outside agriculture was reported in 1957 at 1.7 percent of the nonagricultural wage and salary earners, as compared with 3.7 percent in 1953.

Prices in the Netherlands have, on the whole, risen in pace with increases elsewhere in Europe. Between 1949 and 1958, consumer prices increased at an average annual rate of about 4.5 percent. These price movements, however, were uneven; relatively modest increases in the period 1953–56 were followed by a sharp increase in 1956–57.

The Netherlands, with few natural resources, is in the process of expanding the role of industry in its economy. Its dependence on foreign resources and markets probably will continue to be greater than that of any other European country. Progress already made in attracting new industry and in providing for industrial expansion and the expeditious handling of major public policy problems appear to promise continuing economic gains.

II. Public Economic Policies

A. POLICY FOCUS

Economic growth in the Netherlands, as elsewhere in Europe, occupies a central place in public economic policy. A rapidly growing population, the necessity for expanding the country's industrial base as a means of financing required imports and of providing rising living standards are basic considerations in this policy orientation. High employment has been recognized as a political imperative as well as essential to maximum economic progress. The concurrence of labor and management in public policy decisions has contributed to achieving high employment rates without apparently excessive pressures on industrial cost structures.

Balance-of-payments considerations in the Netherlands condition public policies even more strongly than elsewhere in Europe. Total imports plus exports are very nearly equal to the Dutch national income. The Netherlands' foreign trade is, relatively speaking, about

10 times as important as in the United States. Because of the vulnerability of so open an economy to developments in world markets, the Dutch necessarily place great emphasis upon keeping costs in line with those of other countries. Inflation control, therefore, is regarded as essential to achievement of the nation's growth objectives.

Because of the character of the Netherlands economy, no aspect of its operation can be neglected without hazard to the whole. The immediacy of this interdependence has been thought to require extensive public planning. Such planning appears primarily in the integrated approach that is characteristic of economic policy formation, rather than in significantly more Government ownership or more state interference in business than in most other countries. Paradoxically, in external policy the Netherlands is a vigorous proponent of national free trade policies.

B. PROMOTION OF INVESTMENT AND SAVING

Emphasis on keeping costs competitive has resulted in profits that are generous enough to accommodate a relatively high rate of capital accumulation. Tax policy has contributed to favorable conditions for capital accumulation. The Dutch tax structure is heavily weighted with devices which are aimed at limiting consumption outlays relative to total national product. For example, the personal income tax is quite steeply progressive, particularly at the low- and middle-income range, but has a top effective rate of 64 percent on income in excess of roughly $25,000. A turnover tax applicable to virtually all items with the exception of textile goods and exports is imposed at rates ranging from 5 to 18 percent. Although the corporate income tax has a top marginal rate of 47 percent, two provisions serve to moderate the impact of this tax on capital outlays. One permits accelerated depreciation of one-third of the purchase price of equipment bought or ordered since December 1949. In addition, during the 4-year period 1959–62 taxable profits are reduced by 4 percent per year of the amount spent for new investment between May 20, 1958, and December 31, 1958; 8 percent of new investments made between January 1, 1959, and December 31, 1960, may be deducted in each of 2 years. Maintenance and self-insurance reserves are also allowed, serving to reduce the effective rate of tax on corporate profits.

The Netherlands has not undertaken extensive nationalization of industry, although utilities and the railway system are publicly owned. Investment outlays by Government are accordingly more closely limited to such objects as are usual in the United States. Housing constitutes an exception in that the central government program to overcome the housing shortage is primarily one of financing municipal construction for this purpose. After defense and education, housing advances plus subsidies constitute the largest item in the 1959 budget.

During the 1956–57 investment boom, steps to reduce demand affected business investments as well as expenditure on housing; however, as slack developed in the economy in 1958, the reduced housing goal was retained, keeping resources free for other types of investment.

The high investment requirements of the Netherlands economy has led to development of a comprehensive program to increase the rate of saving. Governmental charges, such as utility prices, social insurance contributions, and those for special services are set at levels which leave no gap to be made up from the general budget. Beyond this, the Government seeks to run a current surplus. Government borrowing has been strictly limited to long-term financing of long-term expenditure programs of investment character. Total public debt has been reduced each year since 1949; short-term public debt has been reduced from 54 percent of the total in 1949 to 26 percent in 1957. To promote private savings, special inducements to construction of one's own home, bonus interest on savings accounts of young persons left on deposit for a specified minimum period, and similar devices have been used. There is, apparently, widespread understanding that an increase in the personal savings rate will permit labor's share in the national income to be maintained, or even increased, without reducing total saving below the level required by investment objectives.[2] Current policy, however, is still explicitly geared to close control of the labor share in line with investment objectives.

C. GOVERNMENT EXPENDITURE TO MAINTAIN NATIONAL INCOME

Sustained national income is regarded as essential to the generation of the saving required to maintain investment at a satisfactory level. Government expenditures are adjusted accordingly. Thus, the current housing goal of 80,000 units a year reflects continuation of the reduction in the annual program (from 100,000 units) that was made to damp the investment boom of 1956–57, but the financing of virtually the entire volume by the Central Government (rather than largely by municipalities) entails an expansion of this budget item by nearly 90 percent over 1958. The 1959 budget, it may be noted, calls for an increase of 460 million guilders (5.5 percent) in expenditures and of 282 million guilders (25 percent) in the deficit, to be covered by long-term borrowing.

D. STABILIZATION OF PRICES AND WAGES

Although currently utilizing both subsidies (especially for agriculture) and a limited form of price control (introduced in its present form reluctantly after 1954 as a prerequisite to wage stabilization), Netherlands stabilization policy relies heavily upon monetary measures. These began with currency reform in 1945, followed by a steady shift in the composition of the public debt from its predominantly short-term character. The central bank and the Treasury appear to work together very closely, and until 1954 the Treasury was actively in the money market, to absorb surplus funds of a super-liquid economy. Since that time, the Treasury has maintained a rollover position in the bill market, covering all deficits by long-term borrowing, while leaving to the bank responsibility for general credit

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[2] See p. 7, above.

and monetary conditions. During 1956–57, the discount rate was raised from 2.5 percent to 5 percent within a period of 18 months, as part of the monetary and credit restraint program. Open-market operations are currently negligible, the central bank having substantially liquidated its portfolio of Government debt instruments.

Direct control of prices was employed from mid-1946, but ceilings were progressively abandoned as Marshall plan aid and expanding output made this possible. Reintroduction of price control, noted above, was limited to general agreement that prices would be held in check, even in the face of wage increases, unless the price rises were approved by the Government.

In the control of general price movements, considerable importance is generally attached to the Dutch system of wage control. Collective bargaining is on an industrywide basis. It is effected under the supervision of the Government, which advises both labor and management groups concerning a tolerable range within which wage contracts may be negotiated. The contracts reached by labor and management representatives become effective only with the approval of the Government. Once approved, all employers are required to abide by the wage patterns negotiated for their respective industries. Some differentials are permitted on the basis of revision in job classification and performance requirements. There are some indications that this system is under considerable pressure not only from employees but some employers as well, who find, in the context of an increasing dynamism, that fixed wage patterns may frustrate their efforts to get the labor force required for new or expanded enterprise.

Cooperation between labor and business through most of the postwar period has, in general, served to restrict wage increases and unit wage costs. For example, when a 12 percent wage increase in 1956—the demand for which has been generated by the rapid increase of profits in the 1955–56 boom—resulted in a level of spending that jeopardized the balance of payments, unions agreed to major modifications as part of a program checking both consumption and investment. The vigorous measures undertaken at this time, referred to above, quickly restored balance as exports gained over imports.

Labor cooperation in limiting wage demands appears to reflect the broad representation of labor interest in government economic policy determination. The Social and Economic Council, composed of 15 members each from business, labor, and the general public, is responsible for preparing the national economic policy recommendations each year. Although these recommendations must be approved by the Parliament, the unanimous recommendations made by the Council in the past have been subject to little legislative modification. These broad policy determinations include matters dealing with both labor and property shares in the national income and serve to provide an overall framework for wage negotiations.

TABLE 13.—*Selected economic indicators for the Netherlands, 1948, 1950, 1953–58*

Indicator		1948	1950	1953	1954	1955	1956	1957	1958	Percent increase, 1948–57	Annual rate of growth, 1948–57
Gross national product [1]	Millions of 1954 guilders.	19,850	22,150	25,160	27,170	28,800	29,990	30,700	[2] 30,200	54.7	5.0
Gross domestic fixed capital formation	do	4,170	4,710	5,180	5,730	6,450	6,990	7,180	(3)	72.2	6.2
Residential construction	do	(3)	910	1,080	1,140	1,120	1,270	1,400	(3)	[4] 53.8	[4] 6.3
Other construction	do	(3)	1,520	1,880	1,740	1,880	1,830	1,730	(3)	[4] 13.8	[4] 1.9
Machinery and equipment	do	(3)	2,280	2,220	2,850	3,450	3,890	4,050	(3)	[4] 77.6	[4] 8.6
Public consumption	do	3,060	2,950	3,620	3,880	4,010	4,110	4,010	(3)	31.0	3.0
Defense	do	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)		
Civil	do	(3)	(3)	(3)	(3)	(3)	(3)	(3)	------	------	------
Private consumption	do	14,080	14,710	15,220	16,310	17,620	19,260	19,110	(3)	35.7	3.5
Real per capital gross national product	1953=100	84	91	100	107	112	115	117	[2] 113	39.3	3.7
Defense as percent of gross national product	Percent	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)	------	------
Gross domestic fixed capital formation as percent of gross national product.	do	21.0	21.3	20.6	21.1	22.4	23.3	23.4	(3)	------	------
Residential construction as percent of gross domestic fixed capital formation.	do	(3)	19.3	20.8	19.9	17.4	18.2	19.5	(3)	------	------
Other construction as percent of gross domestic fixed capital formation.	do	(3)	32.3	36.3	30.4	29.1	26.2	24.1	(3)	------	------
Machinery and equipment as percent of gross domestic fixed capital formation.	do	(3)	48.4	42.9	49.7	53.5	55.6	56.4	(3)	------	------
Industrial production	1953=100	71	88	100	110	118	124	126	126	77.5	6.6
Unemployment rate [5]	Percent	1.5	2.7	3.7	2.7	1.8	1.3	1.7	(3)	------	------
Hourly earnings [6]	1953=100	80	88	100	111	120	128	146	(3)	82.5	6.9
Consumer prices	1953=100	[7] 81	88	100	104	106	109	120	121	[8] 48.1	[8] 5.0
Wholesale prices	1953=100	75	87	100	101	102	104	107	105	42.7	4.0

[1] At market prices; data rounded to nearest 50,000,000 guilders.
[2] Estimate by the Secretariat, OECC.
[3] Not available.
[4] 1950–57.
[5] Registered unemployment as percent of nonagricultural employees plus registered unemployed. Nonagricultural employment is estimated after 1953.
[6] In 4 branches of industry.
[7] For 1949.
[8] 1949–57.

Source: Organisation for European Economic Co-operation. (See note to table 1.)

SWEDEN

I. Economic Development Since 1948

The Swedish economic record since 1948 shows employment well sustained at high levels, the labor market being characterized by continually excessive demand over supply until the second half of 1957; a rate of expansion in output limited by the slow growth of the labor force and by limitations on the possibility of raising the high rate of investment; and constant inflationary pressure. These developments were accompanied by an average rise between 1948 and 1957 of 8.1 percent per year in hourly earnings and of 4.5 percent in consumer prices. In the second half of 1957 activity began to slacken and 1958, therefore, showed more unemployment and the lowest rate of expansion since 1948.

Like most Western European countries, Sweden had its highest rate of increase in output prior to 1950. From 1951 to 1953 the rate slowed drastically—from almost 6 percent (real gross national product) to less than 2 percent per year, and then accelerated to over 4 percent per year. In 1958 output increased about 1 percent—half as great a rise as for all OEEC countries combined. Real private consumption increased throughout the period to 1957 at an average annual rate of 2.4 percent, somewhat more than half that for all OEEC countries.

The fraction of total output devoted to domestic fixed capital formation was relatively high throughout the period, averaging 19.1 percent annually, as compared with a rate of 17.2 percent for all OEEC countries. In terms of the annual increase in the amount going into capital formation, however, the rate was relatively low—4.3 percent as compared with 7.3 percent.

The slower rate of growth in investment and in total output than in many European countries reflect, in considerable part, the fact that Sweden entered the postwar period at a very high level of activity and investment, while most of Western Europe was operating at relatively low rates of resource use as an aftermath of the war. The greater rate of increase in the other countries thus represented catching up. Despite the comparatively moderate rate of expansion, per capita real product in Sweden has been the highest in Western Europe. Therefore, the Swedish experience more closely resembles that of the United States than that of the other European countries.

II. Public Economic Policies

A. POLICY FOCUS

As in the United States, the United Kingdom, and most Western countries, the end of World War II found the economic policy debate in Sweden focused upon the likelihood of a fall in prices after the end of the war and consequent danger of a depressive reaction upon employment and output. The main focus of policy, therefore, was upon the problem of maintaining full employment in the face of difficulties in securing adequate supplies of raw materials and fuel, a hazard of a failure of effective demand, and a tendency of prices to fall. According to some observers of the Swedish scene, this seems to have persisted for some time even in the face of experience with contrary inflationary tendencies. Since 1953, many of the bottleneck problems seem to have been reduced to insignificant proportions. Economic policy has come to be directed toward coordinating public and private policies to secure simultaneously full employment, adequate growth, and price stability.

B. ECONOMIC POLICY COORDINATION

There has been much interest in the postwar period in the fact that the Scandinavian countries, including Sweden, have made a thorough trial of the use of national economic budgets as a means of providing the general framework for the coordination of economic policies, both public and private. These national economic budgets have been projections not of rigid output quotas but of national economic goals or objectives within which fiscal, monetary, wage, and price policies could be worked out and coordinated in the national interest. In the first postwar decade there seems to have been reasonable success in achieving the desired division of total output between various investment and consumption uses. But success in maintaining full employment, an adequate rate of growth, and the desired division of output between consumption and investment has not been paralleled by success in preventing the development of continuously rising prices.

It has been characteristic of the Swedish economy of the past decade that the national federations of employers and trade unions have generally been able to agree upon a wage policy that was in line with projected increases in productivity, production, and demand, and hence consistent with a stable general price level. However, since the unemployment rate has been extremely low, individual employers have obtained workers by paying hourly wage rates above the negotiated rates. This has reinforced the effect of shifts to higher paid occupations and of the substitution of piece rates for hourly rates. The combined effect of these factors is the so-called "wage slide" or the "wage drift." Of the total wage increases in the postwar period, about one-half appears to have been due to the negotiated increases and the other half to this wage slide. By means of shifts in taxes and other policies, excessive increases in wage income have not been allowed to upset the consumption-investment balance. On the other hand, the wage-cost push, in spite of increases in subsidies on food prices at times, has been accompanied by a considerable rise in price levels, at least since 1953.

It is generally conceded that economic policy coordination has been both more extensive and more thorough than in many countries. The program is based on an extensive consultation and discussion program among both public and private economic groups. In consequence, appropriate changes in fiscal and monetary policies have been integrated in an attempt to meet changing problems. For example, when private investment tended to run to excessive inflationary expansion in 1956 and 1957, total credit extensions were restricted to the maximum limits reached in late 1955 and controls over building were invoked.

However, in spite of this coordination of public and private policy, the rise in prices has been about 4.5 percent per year—an intermediate rate in comparison with other countries of Western Europe. Sweden thus appears not to have been particularly more successful than other countries in maintaining price-level stability.

C. THE TOOLS OF ECONOMIC POLICY

The postwar years have witnessed a gradual reduction of direct economic controls, interrupted briefly during the Korean boom. Wages are determined by free collective bargaining, prices at present are free from direct controls, and fiscal and monetary measures are similar in many respects to those in the United States. There are some export and import controls, and direct regulations of the amount of building activity continued until the end of 1958.

Monetary and credit policy

The Swedish use of monetary measures to constrain inflationary pressures has largely taken the form of direct attacks upon the interest rate structure by facilitating the transfer of funds from the short-term to long-term markets, by favoring conditions which will aid in financing housing and other governmental programs, by setting liquidity ratios as well as cash reserve requirements, and by rationing and quasi-rationing of advances.

In practice the discount rate itself has not been much used in recent years. Sweden is representative of the policy followed by a few central banks which do not discount on the basis of a published rate but instead charge rates according to circumstances and the general state of the market. The bank does publish an official discount rate but this rate does not actually determine the availability or cost to commercial banks of borrowing from the central bank but is employed primarily as an indicator of monetary policy. When the commercial banks need cash they are obliged to seek loans from other commercial banks or to sell Treasury bills or bonds to the Riksbank.

During most of the postwar period the operations of the central bank in Sweden have been a major factor in the Government bond market with apparently most of the operations directed specifically at the long-term end of the market, pegging it at progressively higher interest rates. Since 1954 the stated policy has been to abstain from supporting Government bonds and the central bank has been in the market both as a seller and as a buyer, though on balance not supplying the market with the full amount of reserves that would have been needed to meet all credit demands.

Fiscal policy to influence investment

Of particular interest is the Swedish use of fiscal policy, particularly taxation, to affect the volume and character of investment. As in other European countries, some investment is done directly by the Government. They also influence the amount and character of building activity through the use of Government subsidies. This has been particularly true in the case of residential construction where subsidies have been used to hold down costs so that rent increases above the level of 1942 could be held to the barest minimum. Whenever inflationary trends developed, these instruments were used to slow down the volume of investment, particularly residential construction.

More important has been the use of tax policy to influence investment. One approach has been the experimental use of tax devices affecting the amount of or proportion of investment that may be written off each year for tax purposes. So far as industrial buildings are concerned, the Swedish rule is a flat 3-percent-a-year depreciation. In regard to machinery and equipment, corporations and some other forms of business organization in the past have had the privilege of writing off these assets at their discretion so long as the writeoff for tax purposes was the same as that shown in the books of the corporation. After some provisional restrictions in 1952 and 1954, new rules were imposed in the tax law in 1955. These permit 30 percent depreciation allowances in each of the first 2 years and 20 percent thereafter. The restrictions were intended to reduce the liquidity of corporations in boom periods, thus making monetary policy more effective in holding investment down to a noninflationary level dictated by availability of resources. When business activity slackened in 1957–58, the provisions were liberalized.

A particularly distinctive use of tax policy has been the imposition of an investment duty, or direct excise upon the value of new investment, when restraint on expansion has been deemed necessary. This was first imposed in 1952, at a rate of 12 percent. In 1954 it was abolished and in 1955 it was reintroduced, at the same rate. With recessionary developments apparent late in 1957, the tax was again eliminated as of the end of that year. This move was coupled with an expansion of Government investment expenditures and contributed to an expansion of private investment expenditures in 1958 approximately twice as great, in money terms, as that in the public sector. These and related anticyclical policies contributed to maintaining gross national product, which is estimated to have edged up slightly from 1957.

Equalization investment funds

Along with this, since 1938 there has been provision for the establishment of so-called investment funds for business cycle equalization purposes under the regulation of the Labor Market Board. Under this provision of law, Swedish corporations and other economic bodies, mainly cooperatives, have been able to reduce their taxable profits by allocating a share of profits to these equalization investment funds. Since 1955 the regulations provide that up to 40 percent of net profits before taxes may be placed in such an investment fund and the amount deducted from gross income in preparing tax returns. As a condition for this grant, 40 percent of each such fund must be placed in a non-interest-bearing account in the Riksbank. No part of the fund may be used by the company within 5 years without authorization from the Labor Market Board. After 5 years, they may use up to 30 percent of the funds in any one year. Authority to use the funds is obtained from the Labor Market Board, which makes its determination on the basis of whether the proposed investment is productive and of employment conditions prevailing at the time. Use of such funds without authorization, or for purposes other than those stipulated by the Board, would subject the entire amount to taxation as income in the year such use was made and also subject the amount used to a penalty tax of 10 percent.

These investment reserve funds have grown in importance mainly since 1955, when interest in them increased because of the tightening of depreciation allowances. The funds amounted to 650 million kroner by the close of 1957. In 1957–58 the Labor Market Board became somewhat more liberal in granting permission to use these investment funds in view of the increased unemployment, but no general licenses for their uses have been issued.

TABLE 14.—*Selected economic indicators for Sweden, 1948, 1950, 1953–58*

Indicator		1948	1950	1953	1954	1955	1956	1957	1958	Percent increase, 1948–57	Annual rate of growth, 1948–57
Gross national product [1]	Millions of 1954 Swedish kronor.	33,227	37,171	39,339	41,806	43,337	44,781	46,422	[2] 46,800	39.7	3.8
Gross domestic fixed capital formation	do	6,276	6,866	7,814	8,589	8,579	8,837	9,134	([3])	45.5	4.3
Residential construction	do	1,471	1,775	1,929	2,216	2,222	2,351	2,388	([3])	62.3	5.5
Other construction	do	2,400	2,343	3,130	3,315	3,395	3,462	3,569	([3])	48.7	4.5
Machinery and equipment	do	2,405	2,748	2,755	3,058	2,962	3,024	3,177	([3])	32.1	3.1
Public consumption	do	4,913	5,548	6,640	6,999	7,203	7,547	7,799	([3])	58.7	5.3
Defense	do	1,290	1,571	2,048	2,205	2,142	2,226	2,245	([3])	74.0	6.3
Civil	do	3,623	3,977	4,592	4,794	5,061	5,321	5,554	([3])	53.3	4.9
Private consumption	do	22,974	24,198	25,160	26,272	27,262	28,044	28,546	([3])	24.3	2.4
Real per capita gross national product	1953=100	88	97	100	106	109	112	115	[2] 115	30.7	3.0
Defense as percent of gross national product	Percent	3.9	4.2	5.2	5.3	4.9	5.0	4.8			
Gross domestic fixed capital formation as percent of gross national product.	do	18.9	18.5	19.9	20.5	19.8	19.7	19.7			
Residential construction as percent of gross domestic fixed capital formation.	do	23.4	25.9	24.7	25.8	25.9	26.6	26.1			
Other construction as percent of gross domestic fixed capital formation.	do	38.2	34.1	40.1	38.6	39.6	39.2	39.1			
Machinery and equipment as percent of gross domestic fixed capital formation.	do	38.3	40.0	35.3	35.6	34.5	34.2	34.8			
Industrial production	1953=100	88	95	100	104	111	115	119	120	35.2	3.4
Unemployment rate [4]	Percent	2.8	2.2	2.9	2.6	2.4	3.0	3.0			
Hourly earnings [5]	1953=100	63	68	100	104	111	120	128	[6] 134	103.2	8.1
Consumer prices	1953=100	77	79	100	101	104	109	114	119	48.1	4.5
Wholesale prices	1953=100	72	78	100	99	103	108	110	107	52.8	4.8

[1] At market prices.
[2] Estimated by the Secretariat, OECC.
[3] Not available.
[4] Unemployed members of trade unions as percent of all members. Beginning 1953, average of 6 months.
[5] Mining and manufacturing.
[6] 1st 3 quarters.

Source: Organisation for European Economic Co-operation. (See note to table 1.)

UNITED KINGDOM

I. Economic Development Since 1948

The economic record of the United Kingdom throughout the period since 1948 shows highly favorable employment conditions combined with a relatively low rate of growth in productive capacity and, especially, in production, and considerable instability in the level of prices. Since 1948, unemployment (measured by the ratio of wholly unemployed to the estimated number of insured employees) has averaged about 1.5 percent. Even in the recessionary developments of 1958, unemployment rose only slightly above 2 percent. This high rate of employment was accompanied, between 1948 and 1957, by an annual average increase of 6.5 percent in hourly earnings and of 4.7 percent in consumer prices.

Despite these high rates of employment, expansion of total economic activity, while steady, has been relatively slow. Between 1948 and 1957 real gross national product increased at an average annual rate of 2.8 percent, somewhat more than one-half the rate reported for OEEC member countries combined. In 1958 the increase, which in most European countries merely slackened, gave way to a leveling off or possibly a slight decline. Industrial production rose on the average about 3.9 percent annually between 1948 and 1957. Real private consumption increased steadily in the United Kingdom during this period at an average annual rate of 2 percent, less than half that for all OEEC countries combined.

These relatively low rates of growth in total production are associated with comparatively low rates of capital formation. Between 1948 and 1957, real gross domestic fixed capital formation increased at an average annual rate of about 5.1 percent. The comparable rate for all OEEC countries combined was 7.3 percent. These expenditures in the United Kingdom averaged 13.7 percent of total gross national product over this period, compared with 17.2 percent for all OEEC countries.

A partial explanation for this relatively low rate of capital accumulation in the United Kingdom is the persistently sensitive balance-of-payments problem. Roughly 50 percent of the United Kingdom's food supplies are imported. Virtually all of its industrial raw materials, with the notable exception of coal, are obtained from foreign sources. Accordingly, more vigorous efforts to expand industrial capacity would probably have placed substantially greater pressure on the nation's trade balance. Indeed, the investment boom of 1954–55 quickly resulted in a strong drive against the pound, aggravated by adverse speculation. Falling exports and rising imports quickly led to monetary and fiscal efforts to curb the rising demand associated with the investment boom.

II. Public Economic Policies

A. Policy Focus

The record indicates the relatively heavy emphasis given in the United Kingdom to a high and stable rate of employment and the lesser emphasis given to price stability and to economic growth. To a considerable extent, limitations on growth have reflected the dependence of the United Kingdom economy on foreign sources of supply; by the same token, domestic price pressures reflect, at least in part, international price developments. Moreover, in order to maintain the position occupied by the United Kingdom as an international financial center, and particularly to discharge its responsibilities as banker for the sterling area, all economic policies have been related to the nation's balance-of-payments situation and its effects on the stability of the pound in world markets. Efforts at expansion, which tend to depreciate sterling have, therefore, had to be balanced against considerations of price-level stabilization.

Since the war, moreover, the balance of payments has been burdened by debt service resulting from the war and by other overseas payments required in consequence of postwar policy commitments. Recurrent crises in the balance of payments have been surmounted over much of the period since 1948 through policies that tended to check expansion of the domestic economy.

B. DIRECT ECONOMIC CONTROLS

Like other countries of Western Europe, the United Kingdom came out of the war with a well-developed apparatus of economic controls. These were dismantled rather more slowly than elsewhere; it was not until mid-1954 that the Conservative government, after 20 months in office, ended the last of food rationing. Purchases still continue to be taxed, at rates varied by class of goods, as a means of restricting consumption, and installment buying (hire purchase) continued under regulation until October 1958.

The United Kingdom, like its European neighbors, has a nationalized sector of industry (amounting to about 20 percent) as well as an important public investment sector (including housing) in the more conventional sense. Decisions in both areas have been conditioned by overall economic policy requirements. Since the elimination of rationing and direct control of prices and wages, policy directed to the private sectors has relied primarily on general fiscal and monetary controls, coupled with such specific measures as purchase tax, hire-purchase regulations, import restrictions, and investment allowances.

A further important area of Government intervention in the economy is the very broad social-security system, including a comprehensive national health service. Budgetary expenditures here have been a significant component of total consumption. The fact that, as private consumption and investment have expanded at a relatively slow rate, total demand has nevertheless been so well sustained from the public sector as to require continued restrictive measures is a significant key to the high level of employment that has characterized the British economy since the war.

C. MONETARY AND FISCAL POLICY

Although the Bank of England enjoys virtually complete autonomy in determining and guiding monetary policy, its policies are closely coordinated with those of the Government. Both fiscal and monetary measures have been used in efforts to achieve employment and price-level stability and to promote economic growth. In part, this comparative lack of specialization of public-policy devices reflects the relatively high degree of flexibility in budget and tax policies possible under the British governmental system.

The use of monetary and fiscal devices for stabilization purposes may be illustrated by experience during the 1955–58 investment cycle. Various actions taken in 1954 and 1955 were associated with a vigorous expansion of private-investment expenditures in 1955. These actions included an across-the-board income tax cut, removal of controls on consumer credit, and provision of an investment allowance permitting an offset against taxable business income, over and above the ordinary depreciation allowance, of a set percentage of investment in new depreciable facilities.

To counter the resulting excess demand, both tax and credit measures were employed in 1956. The investment allowance was withdrawn, and purchase tax on consumer durables was increased. Consumer credit controls were tightened, ceilings were imposed on the volume of bank lending, the Bank of England discount rate was raised sharply, and the Capital Issues Committee restricted the volume of new corporate issues to the money markets.

The leveling off of economic activity and the increase in unemployment in late 1957 and 1958 evoked a coordinated easing in monetary and fiscal restraints. The discount rate was reduced from 7 percent to 4 percent, consumer credit controls were eliminated, bank loan ceilings were removed, and the Capital Issues Committee eased restraints on new corporate financing in the money markets. Purchase tax rates were reduced, and initial allowances on new depreciable facilities were liberalized. At the same time, public investment outlays were expanded and efforts were made to spur public housing.

Features of United Kingdom taxation

Extensive use of tax devices has been made during the postwar period to influence both the level and the composition of economic activity. Over much of this period, considerable stress has been placed on restraining the level of private consumer outlays in order to enhance the availability of resources for capital formation. This emphasis is reflected in the relatively high rates at which individual income is taxed, the use of purchase taxes, the differential tax that until 1958 was payable by a corporation on dividend distributions, as well as by the liberal treatment of depreciation.

The individual income tax consists of a standard rate imposed at 42.5 percent combined with a graduated surtax at rates ranging upward to a maximum of 50 percent on income in excess of £15,000. The impact of the tax on low-income individuals is mitigated by provision of an earned-income relief, allowances for children, as well as a personal exemption that takes account of marital status, and various reliefs for aged individuals.

Corporate earnings are taxable at the standard rate of income tax, plus the additional profits tax. The latter is currently 10 percent, bringing the total tax to 52.5 percent.

The effect of high corporate tax rates is substantially alleviated by the generally liberal treatment of depreciation. In addition to the use of the declining-balance method for computing depreciation charges, over much of the postwar period the taxpayer has been able to write off an additional fraction of the cost of new facilities in the year of acquisition. These "initial allowances" now are 30 percent of the cost of machinery and equipment and have been as much as 40 percent. These additional first-year allowances reduce the basis of the facilities upon which future depreciation may be claimed. For a brief period in 1955 and early 1956, initial allowances were replaced by an additional investment allowance, which permitted the taxpayer to charge against taxable income between 10 and 20 percent of the cost of new facilities in the year of their acquisition. These investment allowances did not reduce the asset's depreciable basis; this permitted recoupment of 110 to 120 percent of the asset's cost.

On the whole, the United Kingdom tax system bears relatively more heavily on consumption than on investment. In 1957, for example, about 46 percent of total tax receipts were derived from levies on consumption outlays. The net impact on consumers is considerably less than indicated, however, by virtue of the substantial public consumption provided.

Instruments of monetary and credit policy

The United Kingdom has pursued a budgetary policy in the central Government's "revenue and expenditure account" that has yielded a surplus in every year since 1953. The "capital account," or what is known as "below the line," has required relatively modest borrowings, supplemented by small increases in the fiduciary currency issue of the Bank of England, to cover net lending to local authorities and public corporations.

In the United Kingdom as elsewhere in Europe, aggressive use is made of credit policy as a stabilization device. Selective credit controls, directions to commercial banks concerning the maximum volume of lending consonant with stability, and control through the Capital Issues Committee over the volume of corporate security issues are illustrative of the devices that have been employed to supplement more traditional forms of central bank control over monetary and credit conditions.

Central banking practice makes extensive use of the discount or Bank rate in this connection. The Bank of England has long adhered to the policy of a penalty rate, which has rarely been the underlying philosophy of discount-rate practices by the Federal Reserve Banks. In the United States the longstanding and strong tradition (though there is some evidence of its recent weakening) against member-bank borrowing at the Federal Reserve banks has had a sufficiently general deterrent effect on American banks to keep them from seizing upon the opportunity to profit by a difference between the discount rate and the prevailing rate on short-term Treasury bills. The objective in England has been to keep bank rate at about the rate received by the borrowing bank on its own loans and investments, more with an eye to cost effect, so that the central bank will be looked to only as the lender of last resort.

Illustrative of the use made of bank rate since its postwar restoration as a main regulating element in the money market are the changes during 1957–58. When in February 1957 the bond market indicated that a further decline in short-term interest rates was anticipated, bank rate was lowered although it was specifically noted that economic conditions did not warrant easier availability of credit generally. By September the situation had altered markedly. A divergence between the prices of gilt-edged securities and those of ordinary shares was interpreted by the Exchequer as reflecting anxiety about the course of wages and prices and about the international position of sterling. New measures to restrain domestic demand were imposed and bank rate was raised in a dramatic move from 5 percent to 7 percent. The money and security markets reacted promptly, to check and reverse the disquieting tendencies. As confidence was gradually revived and interest rates tended to fall, the 7 percent rate gave way to 6 percent 6 months later; a little more than a year after the dramatic increase, bank rate was down to 4 percent.

During most of the postwar period, general credit policy has been supplemented by direct controls under the Control of Borrowing Order and the operations of the Capital Issues Committee. While the influence of the Government upon the level of bank credit secured through "suasion" and requests to restrict or expand advances has been in no way lessened, the policy of the Government toward capital transactions since the spring of 1958 has been to relax if not abandon controls through the Capital Issues Committee. Instead of limiting its approval to "urgent" proposals, the committee has now been directed to assent to applications which, while not of immediate urgency, anticipate the future growth of requirements. Exemption limits on transactions requiring approval have been greatly increased. Debt issues still require the formal consent of the Treasury.

As a final observation, most decisions involving long-run credit policy are temporarily in suspense in the United Kingdom awaiting the recommendations of the Radcliffe Committee, which was appointed in May 1957 "to inquire into the working of the monetary and credit system." Even the technique of the "official request" to restrict total advances, as made to the banks several times in recent years, although efficacious, has been recognized as possibly damaging both to the banks and to the public interest if continued too long. Creation of the Radcliffe Committee demonstrated recognition that all such elements of existing machinery need to be reviewed. Even traditional procedures of long standing are currently being scrutinized or are looked upon as interim arrangements.

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TABLE 15.—*Selected economic indicators for the United Kingdom, 1948, 1950, 1953–58*

Indicator		1948	1950	1953	1954	1955	1956	1957	1958	Percent increase, 1948–57	Annual rate of growth, 1948–57
Gross national product [1]	Millions of 1954 pounds sterling.	[2] 15,106	[2] 16,198	17,179	17,995	18,579	18,962	19,304	[2] 19,300	27.8	2.8
Gross domestic fixed capital formation	do	1,857	2,110	2,340	2,539	2,682	2,979	2,920	(3)	57.2	5.1
Residential construction	do	425	408	622	644	579	565	552	(3)	29.9	2.9
Other construction	do	420	575	590	646	721	811	867	(3)	106.4	8.3
Machinery and equipment	do	1,012	1,127	1,128	1,249	1,382	1,421	1,501	(3)	48.3	4.5
Public consumption	do	2,440	2,640	3,229	3,208	3,169	3,212	3,123	(3)	28.0	2.8
Defense	do	[2] 1,015	[2] 1,030	[2] 1,596	1,554	[2] 1,470	[2] 1,458	1,300	(3)	28.1	2.8
Civil	do	[2] 1,425	[2] 1,610	[2] 1,633	1,654	[2] 1,699	[2] 1,754	[2] 1,823	(3)	27.9	2.8
Private consumption	do	10,628	11,209	11,421	11,959	12,363	12,469	12,706	(3)	19.6	2.0
Real per capital gross national product	1953=100	[2] 89	[2] 95	100	104	107	109	111	[2] 110	24.7	2.5
Defense as percent of gross national product	Percent	6.7	6.4	9.3	8.6	7.9	7.7	6.7	(3)		
Gross domestic fixed capital formation as percent of gross national product.	do	12.3	13.0	13.6	14.1	14.4	14.8	15.1	(3)		
Residential construction as percent of gross domestic fixed capital formation.	do	22.9	19.3	26.6	25.4	21.6	20.2	18.9	(3)		
Other construction as percent of gross domestic fixed capital formation.	do	22.6	27.3	25.2	25.4	26.9	29.0	29.7	(3)		
Machinery and equipment as percent of gross domestic fixed capital formation.	do	54.5	53.4	48.2	49.2	51.5	50.8	51.4	(3)		
Industrial production	1953=100	82	94	100	108	114	114	116	114	41.5	3.9
Unemployment rate [4]	Percent	1.6	1.6	1.7	1.4	1.1	1.2	1.5	[5] 1.9		
Hourly earnings [6]	1953=100	75	80	100	106	115	124	131	[7] 135	74.7	6.4
Consumer prices	1053=100	77	81	100	102	106	112	116	119	50.6	4.7
Wholesale prices [8]	1953=100	[9] 79.9	85.3	100.0	100.3	103.4	108.3	111.5	112.8	[10] 39.5	[10] 4.2

[1] At market prices.
[2] Estimate by the Secretariat, OEEC.
[3] Not available.
[4] Wholly unemployed (registered) as percent of estimated number of insured employees.
[5] 1st 10 months.
[6] In manufacturing, yearly data are for October.
[7] For quarter; quarterly data are for April.
[8] All manufactured products other than fuel, food, and tobacco.
[9] For June 30, 1949.
[10] 1949–57.

Source: Organisation for European Economic Co-operation. (See note to table 1.)

III
APPENDIXES

CONTENTS

APPENDIX A

Selected Materials Assembled for Committee Use

APPENDIX B

APPENDIX A

Selected Materials Assembled for Committee Use

WESTERN EUROPE IN GENERAL

COMPARATIVE FEATURES OF EIGHT NATIONAL BANKING SYSTEMS OF WESTERN EUROPE[1]

BELGIUM

Central bank:	
Ownership	50 percent Government owned since 1948 (remaining shares freely traded on stock exchange).
Selection of governor	Appointed by Crown for 5-year term.
Selection of board	Appointed by Minister of Finance based on nomination and selection by bank's council of regents made up of industrialists, professors, trade unionists, and other nonbankers.
Disposition of profits	As in a banking joint stock company.
Relation to Finance Ministry	Minister of Finance has right to control all operations of bank, and a Government-chosen commissioner supervises operations to insure that they are conducted in the public interest. Strong personalities in the governor's chair have on occasion demonstrated considerable independence and even influenced trends in Government finance.
Role in Government finance	Makes funds available to Treasury within a limit of $200,000,000 equivalent.
Commercial bank reserves:	
Form	Cash reserve: Deposits with central bank and Postal Check Office or cash. Secondary liquidity reserve—Government securities and call loans in addition to cash and central bank deposits.
Range of variation	Cash reserves: 4–6 percent; current rate 4 percent. Secondary reserve: 50 to 65 percent depending on size and type of bank.
Established by	Banking commission with approval of Finance Minister and Economics Minister.

FRANCE

Central bank:	
Ownership	100 percent Government owned since 1946.
Selection of governor	Appointed by Government decree for an indefinite term.
Selection of board	Four ex officio heads of principal Government financial institutions, 7 appointed by Minister of Finance to represent various economic interests, and 1 representative of the bank's staff.

[1] Including Belgium and Switzerland (see letter of transmittal, par. 3). Prepared by the committee staff.

Central bank—Continued

Disposition of profits	Committed to amortization of advances made by the bank to the Treasury in 1957.
Relation to Finance Ministry	In practice the Government in power influences monetary policy through the National Credit Council of 43 members, including its president, who is a Minister designated by the Government, and its vice president, the Governor of the Bank of France. Seventeen members represent Government departments or public financial institutions and the remaining 24 are appointed by the Minister of Finance on basis of nominations by economic interest groups. Although formal powers of council are advisory it effectively determines broad lines of policy.
Role in Government finance	Makes loans to Treasury under terms of special agreement between bank and Treasury. In practice advances even though subject to repayment have become permanent or absorbed by successive revaluations of the bank's reserves.

Commercial bank reserves:

Form	25 percent in short-term Government securities.
Range of variation	In addition 60 percent of short-term liabilities must be maintained in liquid assets, requirements being dictated more to insure good banking practice than for purposes of monetary policy.
Established by	Central bank on advice of Credit Council in agreement with Finance Minister.

GERMANY

Central bank:

Ownership	100 percent Government owned since incorporation in 1948.
Selection of governor	Appointed by the President of the Republic after consultation with the bank's council of directors.
Selection of board	Same as governor.
Disposition of profits	20 percent to legal reserve until it amounts to 5 percent of note circulation; 10 percent to other reserves up to amount of original capital; 40,000,000 deutschemarks (approximately $9.5 million) for purchase of certain Federal indebtedness; any remainder transferred to Federal Government.
Relation to Finance Ministry	By law the Bundesbank is "independent of instructions of the Federal Government" although bound "to give due consideration to the general economic policy of the Federal Government and to support such policy within the scope of its tasks."
Role in Government finance	May make direct advances to a limited extent and, without limit, buy and sell in the open market Federal bonds and bills.

Commercial bank reserves:	
Form	Deposits with central bank.
Range of variation	Maximum 30 percent sight liabilities; 20 percent time liabilities and 10 percent savings deposits. Demand deposits: 9 to 13 percent depending on size and location of bank (30 percent for deposits of nonresidents). Time deposits: 7 to 9 percent depending on size bank (20 percent for deposits of nonresidents). Savings deposits: 6 percent (10 percent for deposits of nonresidents).
Established by	Central bank.

ITALY

Central bank:	
Ownership	60 percent owned by the savings banks; remainder by banks and institutions of national interests, various insurance and provident institutions. Power of stockholders are limited, however, to election of auditors.
Selection of governor	After being approved by the Government (in practice the Ministry of the Treasury), the governor, general manager, and vice manager are appointed by the superior council, which is composed of the governor and the 12 elected directors from the bank's 12 main branches.
Selection of board	Elected from the bank's 12 main branches.
Disposition of profits	To Federal Treasury after a dividend of 6 percent to stockholders and the transfer of 40 percent to reserves.
Relation to Finance Ministry	Subject to Treasury supervision although never merely an instrument of Treasury; its opinions in matters of economic and credit policy carry great weight in practice in part because of high caliber of men who have had the governorship.
Role in Government finance	Obligated to make advances up to a limit of 15 percent of budget expenditures but in practice maximum indebtedness has been far below legal limit and Treasury has steadily reduced its "extraordinary" wartime advances.
Commercial bank reserves:	
Form	Interest-bearing account with central bank or Treasury; Government or Government-guaranteed securities deposited with central bank.
Range of variation	20 percent of deposits in excess of 10 times bank capital, or 15 percent of deposits, whichever is smaller; plus 40 percent of increase in deposits after Oct. 1, 1947, up to a ratio (now reached) of 25 percent of total deposits.
Established by	Interministerial Committee on Credit and Savings.

NETHERLANDS

Central bank:	
Ownership	100 percent Government owned since 1948.
Selection of governor	Appointed by the Crown for 7-year term on nomination at a joint meeting of governing board (appointed by Crown) and the board of commissaries (appointed by Minister of Finance).
Selection of board	See above (board of commissaries supervises administration of the bank).
Disposition of profits	All profits transferred to the Government.
Relation to Finance Ministry	Finance Minister is empowered to issue directives to the bank but the latter, in case of disagreement, has the right to appeal to Crown, represented in the person of the Finance Minister.
Role in Government finance	Obligated to make advances on current account to the state each time Minister of Finance considers it necessary. Such advances are noninterest bearing but limited to 15 million florin (approximately $4.0 million). Bank holds in addition more or less static book debt of Government growing out of German occupations.
Commercial bank reserves:	
Form	Deposits with central bank.
Range of variation	Maximum 15 percent. On standby basis a liquidity reserve of 30–45 percent may be required in form of cash, central bank deposits, call loans or short-term Government securities. First 10 million florin in each bank requires no reserves.
Established by	Central bank after consultation with commercial and agricultural banks.

SWEDEN

Central bank:	
Ownership	100 percent Government owned since 1668.
Selection of governor	Elected by directors from among themselves as chief executive officer but chairman of board, rather than governor, appears to be policy head.
Selection of board	Chairman of board is appointed by the Cabinet while other six directors are chosen by the Parliament.
Disposition of profits	Belong to Government.
Relation to finance ministry	Owned and supervised by Parliament, is formally independent of executive branch of Government. Government is, however, represented on board by the chairman and with increased influence of Government, formal independence has now lost all practical significance and bank in practice is wholly subject to desires and direction of executive Government.
Role in Government finance	Acts as banker to Swedish Government. Has pegged Government bond market during most of postwar period but at progressively higher interest rates.
Commercial bank reserves:	
Form	Cash; net deposits with central bank; liquid assets. Under current practice 2/5 must be in cash or deposits with central bank.
Range of variation	Up to 50 percent; current rate not published, varies according to size of bank. Also fixed liquidity requirement of 4 percent on total obligations and 25 percent on sight liabilities.

Commercial bank reserves—Con.

Established by	Legal requirements suspended since 1952. At present set by unilateral recommendation by central bank.

SWITZERLAND

Central bank:	
Ownership	Joint stock company; 57 percent owned by cantons and cantonal banks, remainder by a large number of private shareholders.
Selection of governor	A board of 3 directors appointed by the Cabinet on recommendation of bank council (see below) is responsible authority for operation of bank.
Selection of board	A bank council of 40 members, 15 elected by stockholders and 25 by the Cabinet results in considerable governmental influence in decisions and management of bank.
Disposition of profits	Presumably in routine joint company pattern of prudent retention of reserves.
Relation to finance ministry	Influence of Government is considerable and from time to time the Cabinet has prescribed monetary policies for the bank to follow.
Role in government finance	Bank has purchased Federal securities for temporary investment of funds and "cooperates" in the placing of new Federal and cantonal funds.
Commercial bank reserves:	
Form	Blocked deposits with central bank.
Range of variation	Against short-term liabilities 2½ percent to 4¼ percent depending on type of bank. Additional liquidity requirements (1) in cash, deposits with central bank and Postal Savings System of 2–5 percent increasing according to ratio of short-term liabilities to total liabilities; (2) in short-term assets of 25–50 percent according to ratio of short-term liabilities to total liabilities.
Established by	"Gentlemen's agreement" between central bank and banking system.

UNITED KINGDOM

Central bank:	
Ownership	100 percent Government owned since 1946.
Selection of governor	Appointed by Government.
Selection of board	Do.
Disposition of profits	
Relation to finance ministry	Treasury has authority "from time to time to give such directions to the bank as, after consultation with the Governor of the bank, they think necessary in the public interest."
Role in government finance	Direct loans to Government known as ways and means advances are permitted.
Commercial bank reserves:	
Form	No legal requirements but as a matter of banking practice a minimum liquidity reserve of 8 percent of deposit liabilities is held in cash or deposits with central bank plus 30 percent (minimum) in cash deposit with central bank, call money, commercial bills, or Treasury bills.
Range of variation	See above.
Established by	No legal requirement but carried as a matter of banking practice and moral suasion exerted by the central bank.

THE FIGHT AGAINST INFLATION *

The achievement and maintenance of financial stability has been one of the most intractable problems which has faced Western Europe since the war. It has demanded almost continuous attention by the O.E.E.C. From the outset, it was recognised that internal financial stability was essential, not only for the maintenance of social justice and balanced economic growth within each Member country, but also for the achievement of the Organisation's objectives in the field of trade and payments. Widely disparate movements in prices and internal demand within Europe are bound to lead to balance of payments difficulties, the invocation of escape clauses, the danger of reprisals and, eventually, to the breakdown of co-operative efforts towards freer trade and payments.

It was these domestic and external considerations which led Member countries to pledge that each of them would " ...take such measures as lie within its power to achieve or maintain the stability of its currency and of its internal financial position, stable rates of exchange and, generally, confidence in its monetary system ".[1]

The task of achieving and maintaining financial stability cannot be isolated from the other objectives set by governments in Western Europe, such as rapid economic growth and a high and stable level of employment. In the long run, these objectives are complementary, but nevertheless the fiscal and monetary measures required to maintain financial stability have widespread repercussions throughout the whole economy. The maintenance of financial stability, moreover, depends not only on government policies but also, to an important extent, on the co-operation and good sense of all sections of the community. It is doubtful whether it would be possible to define international obligations with any precision in the complex field of internal finance; it is probable that they would involve a considerable limitation of national sovereignty. Furthermore, the principle of reciprocity, which has guided the Organisation's work on trade and payments, is less tangible and open to more argument in the case

1. Article 7 of the *Convention for European Economic Co-operation*, Paris, April 16, 1948.

*Organisation for European Economic Co-operation Ninth Report, "A Decade of Cooperation, Achievements, and Perspectives," April 1958, Chapter V.

the rise in prices 1947-1957

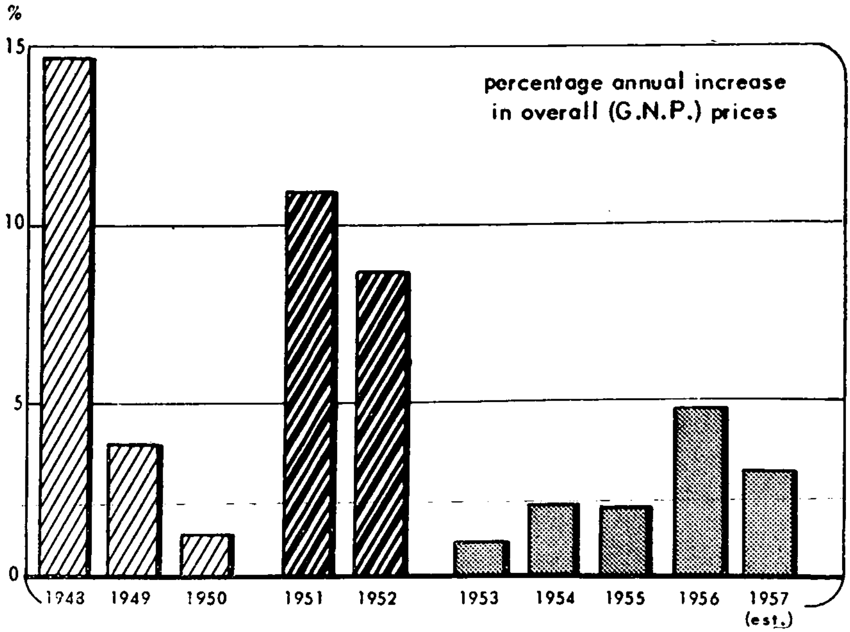

CHART 14

Although the overall (G.N.P.) level of prices in Western Europe has risen continuously since the war, there have been wide variations in the rate of increase. Three phases stand out: 1947-50 when the inflationary pressures generated by the war were gradually being brought under control; 1951-52 when prices rose very rapidly both in Europe and the rest of the Western World following the outbreak of hostilities in Korea; and 1954-56 when upward pressure on prices once more emerged as a general investment boom developed. Since the middle of 1957 the pressure on prices has slackened considerably.

of internal financial stability. The consequences of discordant policies with respect to quantitative restrictions are, for example, much more readily apparent than those following from divergent movements in internal prices and demand. For all these reasons, it has not been possible to establish, within the framework of the O.E.E.C., specific mutual obligations of the kind established with respect to trade and payments, such as those embodied in the Code of Liberalisation and the E.P.U. Agreement.

In this field, therefore, the Organisation's main role has been to stress the importance of financial stability and its fundamental connection with the mutual obligations which Member countries have accepted in the field of international trade. It has sponsored discussions between national officials charged with responsibility for maintaining financial stability; it has commissioned independent experts to examine and report on the policies adopted; and it is a forum where Ministers exchange views on methods for meeting common problems, and discuss and comment on national policies. More generally, the mutual understanding needed in this field has been enhanced by the work on other aspects of economic stability. On a number of occasions, this process of consultation and criticism has led to specific recommendations to individual Member countries concerning desirable changes in their fiscal or monetary policy.

Although the major financial problem facing countries in Western Europe has been one of inflation rather than deflation during the period under review, there have been important changes in the origin, strength and point of impact of the underlying inflationary forces. Broadly speaking, three distinct phases stand out. From 1947 until 1950, the task of reconstructing the war-torn European economy, together with the desire to get rid of rationing and other wartime controls, inevitably gave rise to financial pressures which were only gradually brought under control. The second phase, from mid-1950 until 1952, was dominated by the economic repercussions of the Korean crisis; throughout the world financial stability was threatened by the short-lived but strong surge in demand for raw materials, and the general acceptance of the need to increase expenditures on defence. The third phase saw the return to more normal peace-time conditions. Almost everywhere an investment boom was followed by the re-emergence of inflationary pressure, but the timing and incidence of these new pressures varied markedly from country to country. More recently, investment demand has levelled off in many countries and there are signs that overall demand is slackening.

Curbing Post-War Inflation: 1947-1950

Strong inflationary pressures were inherent in the chaotic economic conditions in Western Europe in 1947. Demand greatly exceeded available resources. Both industrial and agricultural production were below pre-war levels and, in spite of the fact that imports greatly exceeded exports, available resources per capita in the area as a whole were more than 10 per cent smaller than in 1938; in several countries the position was much worse than this — in Germany and Austria, for example, available resources per capita were less than 50 per cent of pre-war. These diminished supplies were confronted with strong demand from all sectors of the economy; consumers, with higher money incomes than pre-war, were pressing for a return to normal living standards, business firms wanted to renew their equipment and replenish stocks, and in the public sector, in addition to the cost of new social measures, there was an urgent need to make good the widespread war damage.

These demands for real resources could be backed by money. War-time financing had led to an enormous increase in the supply of money in Western Europe. In 1947, for example, despite the monetary reforms which had been carried out immediately after the war in some countries, the supply of money was 2 1/2 to 4 times the 1938 level in Sweden, the Netherlands, Denmark, the United Kingdom and Norway, and 8 and 33 times the 1938 level in France and Italy respectively.

In Germany the monetary system had almost completely broke down and most transactions were on a barter basis. In France and Italy, prices were rising freely and confidence in the national currency had been greatly undermined ; in consequence, although people were holding less money in relation to their expenditure than before the war, there was a strong incentive to run down money balances, i.e. to dis-save. In the United Kingdom, the Netherlands and the Scandinavian countries, there was less incentive to reduce savings because prices had been fairly effectively controlled both during and after the war. Nevertheless, money balances were much larger in relation to current expenditure than before the war, and thus the high level of real demand for available resources could be easily converted into a correspondingly high level of monetary demand even without fresh financing by the banking system. Most governments, moreover, were resorting to deficit financing in order to carry out reconstruction programmes, and at the same time memories of the depressed conditions in the 1930's led to a disinclination to restrict credit for fear that this would curtail private investment.

In this situation a rapid increase in production was essential. At the same time, there was an urgent need to stabilise or reduce the supply of money, and in particular to reduce budget deficits. In the report of the Committee for European Economic Co-operation, published in September 1947, the participating countries pledged that they would carry out " independently of any external assistance, the internal measures within their power in fiscal and currency matters and also in the field of production, with the purpose of restricting forthwith calls on the bank of issue and other inflationary practices and of increasing the production of consumer and capital goods ".

This plan of combating inflation by increasing output rather than by drastically reducing demand would not have been possible without a high degree of international co-operation. It implied the continuation of heavy external deficits during the reconstruction period and could not have been carried out without aid from the United States. No less important was the fact that each country was able to go forward in the knowledge that the other O.E.E.C. countries were committed to similar aims of expansion and financial stability.

Considerable progress had been made by the end of 1948; money supply had been stabilised or reduced and budget deficits had been reduced (or budget surpluses increased) in almost every country. In Germany, the monetary reform of June 20, 1948, revolutionised the situation, restoring the monetary system and paving the way for the recovery of production and trade. Total production in Europe increased sharply; but nearly one-half of the increase had to be devoted to reducing the external deficit (see Chart 16, page 103), and thus the imbalance between domestic supply and demand was only moderately reduced. Furthermore, pressure for the removal of direct controls was increasing.

On March 26, 1949, the Council of the Organisation laid down, as the first principle of its Plan of Action for 1949-50 that " at the national level, 1949 should be the year of financial stabilisation in Europe ". Each Member government was requested to report on recent internal developments and the policies which had been, or were going to be, adopted in order to restore financial stability. These submissions were examined by a group of financial experts in collaboration with national officials, which prepared a report for the Council. This procedure, which was used for several years, served a twofold purpose. The preliminary work of preparing and discussing national submissions was of value to the officials and Ministers responsible for financial policy in that it gave them a wider insight into their common problems. The eventual publication of the reports helped them to explain their policies to the general public, whose understanding and co-operation are essential for the success of anti-inflationary policy.

When the first Working Party on internal financial stability met during June and July 1949, it was faced with a complex situation. The national submissions showed that in most cases the rise in prices had greatly slowed down, or had been halted. But, in contrast with this more cheerful picture on the domestic front, a number of countries were having serious balance of payments difficulties; it was becoming clear that the reduction of Europe's deficit with the dollar area would require a further export effort, and that this would probably entail a readjustment of European exchange rates. In their report,[1] therefore, the financial experts, while noting that a fair measure of internal financial stability had been achieved by the middle of 1949, issued a warning that measures necessary to eliminate the external deficit and to encourage domestic investment might well

1. First Report on *Internal Financial Stability*, O.E.E.C., Paris, October 1949, paragraphs 31-34.

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lead to a re-emergence of inflationary pressure. This warning was put to the test by the devaluations of September 1949.

In the months which followed these devaluations, there was a moderate rise in wholesale prices, and some increase in retail prices in a number of countries. These developments, however, largely reflected the influence of higher import prices ; in general, money wages remained remarkably stable and there were few signs of the emergence of a new wage-price chain reaction. Thus, the readjustment of European rates of exchange — without which the return to a flexible peace-time economy would have been impossible — was carried out without seriously disturbing the financial situation within Europe.

In the first place, the change in prices and the terms of trade for any one country was considerably damped down because all the countries with balance of payments difficulties followed the action of the United Kingdom and devalued their currencies by varying amounts. More important was the fact that, by the first half of 1950, the gap between current demand and available resources in Western Europe as a whole had largely disappeared. The second Working Party of experts appointed by the Organisation, which met between March and June 1950, noted in its report that industrial production was by then well above pre-war and that agricultural production had reached its pre-war level. On the demand side there were signs that a recovery in personal savings, following from higher living standards and recovery of confidence in national currencies, was reducing the pressure from consumers. Rationing and price controls had been, or were being, dismantled in almost all countries. Government expenditure, although higher than pre-war, was no longer increasing at the rapid rate of earlier years and in almost all cases current revenue exceeded current expenditure. In the field of private investment, there was a considerable slackening of demand in a number of countries, which may in part have been prompted by doubts concerning the likelihood of continued expansion.

With slackening pressure of demand in all three major domestic sectors, the rapid increase in extra-European exports fostered by the devaluations was met out of increased production without putting new pressure on domestic prices. The Working Party therefore concluded that the position required " a delicate balance between opposing considerations... On the one hand, it might be premature to abandon the means of restraining inflation should that need arise ; on the other hand, it is desirable that advance preparations should be made to meet an unexpected decline in demand and to prevent this from developing into a depression ".[1]

1. Second Report on *Internal Financial Stability in Member Countries*, O.E.E.C., Paris, August 1950, paragraph 103.

The fierce fight against post-war inflation seemed to be nearly over.

The fact that the struggle had to be renewed almost immediately, following the outbreak of hostilities in Korea, should not obscure the nature of the achievement. It is true that in several countries, including Norway, Sweden and the United Kingdom, holdings of liquid assets were still comparatively high in relation to the level of current expenditure, and that in some other countries, notably, France and Germany, confidence in the national currency had been restored only recently. But, nevertheless, by the middle of 1950, a large part of the legacy of excess monetary demand from the 1939-1945 war had been absorbed by the increase in production and prices(see Chart 17, page 107), and most of the apparatus of wartime economic control was being dismantled.

KOREA AND THE RISE IN WORLD PRICES: 1950-1952

The outbreak of hostilities in Korea set off a general buying spree throughout the western world, and led to a wave of inflation which eventually raised prices in Western Europe by about 20 per cent. Although the main fighting in Korea was over by the late spring of 1951, the rise in internal prices — which was more widespread and in many cases more rapid than during the war and post-war inflation — continued throughout 1951 and well into 1952.

The initial impact of the Korean crisis varied considerably from country to country. In countries where memories of wartime shortages were particularly vivid, there was a wave of panic buying which in many cases led to an immediate rise in final prices. In other countries, the price rise was at first confined to imported raw materials and foodstuffs, and it was some time before this was passed on to consumers.

Raw material prices had already been rising before the crisis, in response to the recovery of industrial activity in the United States. The new demand sent prices shooting up, and this, in turn, encouraged speculative buying and stockpiling. Between the beginning of 1950 and the middle of 1951 the average cost of merchandise imports from outside Europe rose by 45 per cent. The impact of these price rises on domestic costs varied from country to country depending on their dependence on imported supplies, but in general the rise in unit import costs was almost as rapid and much more severe than after the 1949 devaluations. Furthermore, when it became clear that these price levels were going to be maintained for some time, there was a burst of anticipatory buying of intermediate and finished products. In 1951 additions to stocks were more than double the average level over 1947-56, and absorbed just over half of the total increase in output.

Within the O.E.E.C. the dangers inherent in the shortage of raw materials and the uncontrolled rise in prices were recognised almost immediately. On October 7, 1950, the Council warned Member countries of the greatly increased dangers in the field of internal financial stability, and instructed the Executive Committee to make an immediate survey of raw material shortages, " particular attention being given to possible ways of keeping prices in check ". On December 2, as a result of this survey, the Council recommended Member countries to impose, where necessary, new controls on the consumption of materials in short supply and " to take all necessary internal measures in regard to raw materials... especially in the sphere of financial policy, to discourage speculative buying, to check undesirable private stockpiling and to keep prices in check ".

In practice, there were delays before effective action was taken, but eventually, action was taken along the lines recommended by the Organisation. In most countries a variety of measures prevented any very large increase in money supply. In many cases discount rates were raised at an early stage; the extension of bank credit was restrained by raising reserve requirements and by regulations or directives from central banks; and restrictions were introduced on mortgage and other forms of consumer credit. In the sphere of fiscal policy, revenue was increased to finance the defence drive and an attempt was made to offset the decline in personal and business savings by increasing government savings. In addition, many countries were forced to re-impose direct controls over prices and the allocation of scarce materials.

The part which the O.E.E.C. played in bringing the problem of shortages and high prices for raw materials into the wider international forum has already been described in Chapter II. In addition to keeping the International Materials Conference in Washington informed of the needs and resources of Member countries, the Organisation attempted to harmonise the controls which had been introduced to limit the consumption of some of these materials. On September 10, 1951, it was decided that all Member countries should prohibit the use of copper and copper alloys in the production of a long list of articles, and similar action was taken later with respect to nickel and nickel alloys.

Despite these efforts, prices of raw materials were abnormally high for many months, and domestic policies were unable to prevent the wave of the consequent reactions on domestic prices and wages from spreading throughout Western Europe. By the time import prices began to fall again, wages had everywhere risen sharply in response to the rise in the cost of living, and this tended to support the higher price level.

International co-operation certainly limited the extent of the disturbance, but governmental action was not bold or quick enough to prevent

the price of imports from outside Europe

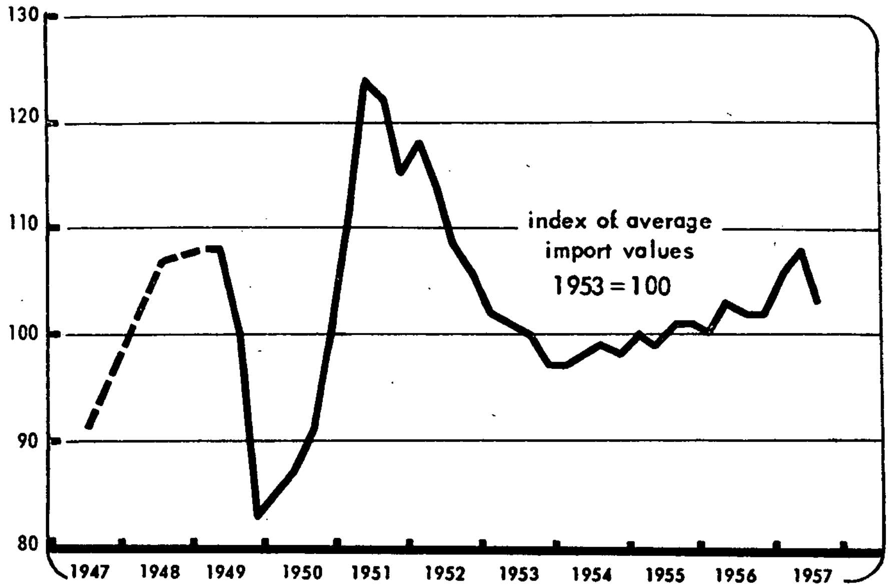

CHART 15

The cost of imports from outside Europe — mainly foodstuffs and raw materials — has an important influence on total costs in the European economy. The disruption of international trade caused by the war led to a large increase in primary product prices relative to the price of manufactured goods. But, by the end of 1949 supplies were improving and prices generally no longer reflected exceptional scarcities.

The outbreak of hostilities in Korea led to a great upsurge in the demand for primary products, the average unit cost of extra-European imports rising by 45 per cent. When the boom broke, import costs fell back to a level about 20 per cent above the end-1949 figure — a net increase of roughly the same magnitude as for domestic wages and prices.

From 1953 to 1956, the average cost of imports moved slowly upwards, a rise in raw material prices more than offsetting a decline for some important foodstuffs.

The sharp rise produced by the Suez crisis in oil and certain other prices proved short-lived. A general downward trend has since become evident with raw material prices weakening as production has increased while the pace of industrial expansion has slackened.

a substantial and permanent rise in world prices. Indeed, in some cases, restrictive measures did not become effective until after demand began to slacken off at the beginning of 1952. Looking back in October 1951, the third Working Party on financial stability reported that " in principle, it would have been possible for concerted action to have been taken throughout the area which would have gone a long way to prevent the serious disturbance which took place. Such action would have required the governments to adopt and implement a common policy on a wide range of matters, including some which lie outside the field normally considered to be concerned with financial stability. In particular, common action

CHART 16

In contrast to private consumption, which increased fairly steadily throughout the ten years, there have been important variations in the growth of the other constituents of final demand.

From 1947 to 1950, the pace was set by the recovery of exports and the pressing need for increased fixed investment to restore and expand Europe's productive potential.

The Korean crisis changed the order of priorities, defence expenditure being increased at the expense of the growth of fixed investment and consumption. At the same time, a sharp stock cycle first added to the pressure of demand in 1951 and then caused some general slackness in 1952 and the early part of 1953.

From 1953 to 1956 fixed investment was the most active element in total demand; housebuilding led the way but was soon followed by a boom in industrial investment. Since the middle of 1956 the growth of investment demand has been slackening.

was needed in the sphere of raw materials. In the event, individual businesses and governments sought to protect their own position by making precautionary purchases... A common decision to restrict the granting of credit for such purchases might have helped, but more direct action to keep demands within a reasonable level was needed ".[1]

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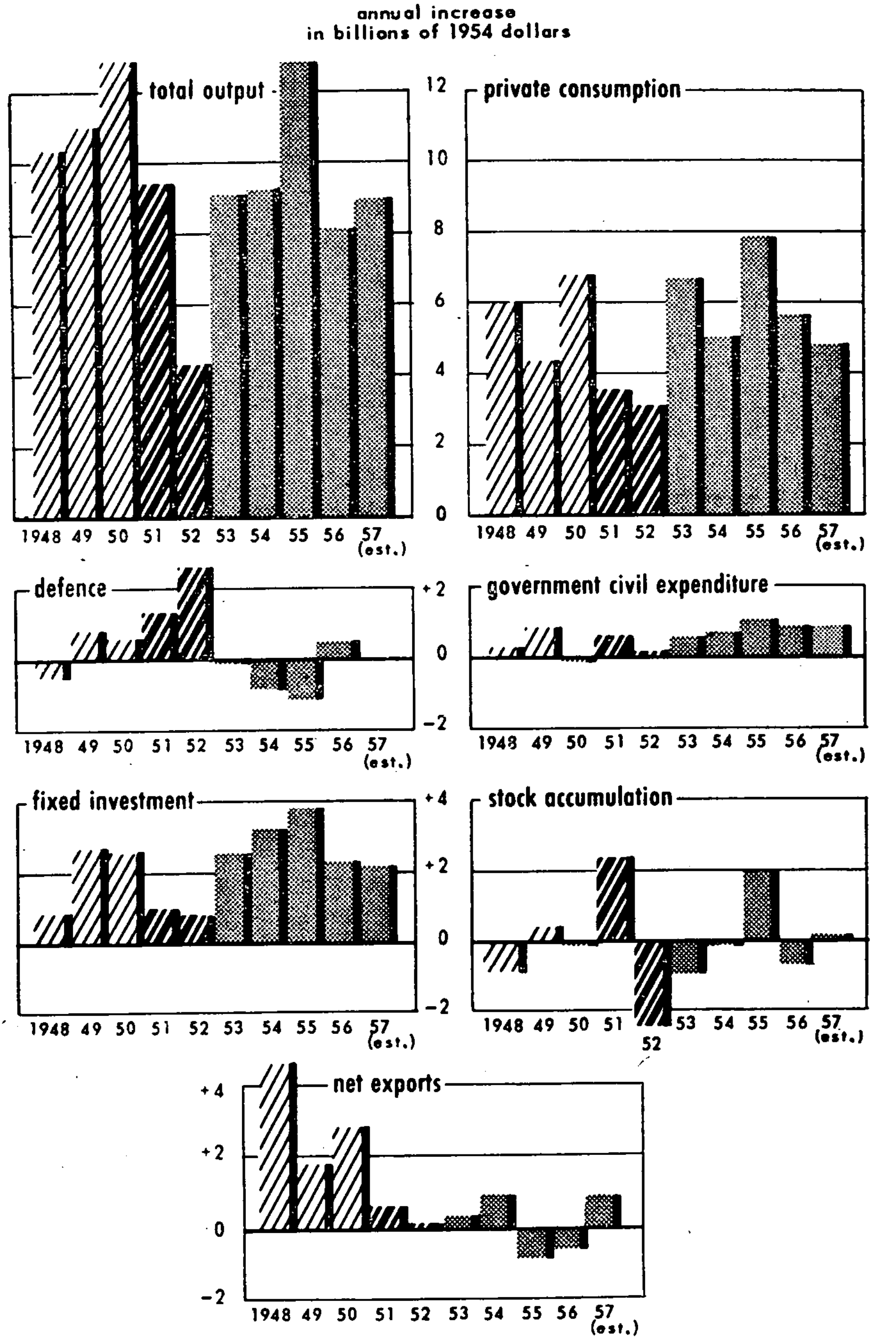
1. Third Report on *Financial Stability and the Fight against Inflation*, O.E.E.C., Paris, November 1951, paragraphs 18 and 19.

constituents of the growth in demand



The Investment Boom and the Re-emergence of Inflation: 1953-1957

In 1953, the economy of Western Europe entered a new phase. For the first time for more than fifteen years economic events were no longer dominated by the aftermath, reality or immediate threat of war. The return to something approaching peace-time conditions led to a change in the standard against which success or failure in the field of internal financial stability had to be measured. A degree of inflation which might have been regarded as an acceptable price to pay for the achievement of overriding objectives during an emergency, could no longer be tolerated under more normal conditions. As far back as 1951, the third Working Party on internal financial stability drew attention to the dangers of what it called " creeping inflation ". It pointed out that although the dangers of run-away inflation are obvious — in that it leads rapidly to the rejection of money as a means of exchange and hence to a break-down of the economic system — slower rates of inflation, if maintained over a number of years, also have deleterious effects.

The Working Party recognised that with creeping inflation money still serves its purpose in day-to-day affairs, but that as a way of holding savings it becomes most unattractive, as do long-term loans, life insurance policies and savings deposits. There are serious difficulties, therefore, both in securing an adequate total of savings and in obtaining an appropriate distribution of this total. Furthermore, confidence in the stability of the currency is undermined, and balance of payments difficulties are aggravated by frequent speculative capital movements. Finally, the Working Party noted that " above all, there are unjust changes in the distribution of income and wealth amongst the population, particularly affecting those in a weak bargaining position or living on pensions or other fixed incomes; the value of past savings held as bonds or money is progressively destroyed; those better placed can maintain or enlarge their share, and are on the alert to do so. A general sense of social injustice and discontent prevails ".[1]

The efficacy and appropriateness of the various instruments of fiscal, monetary and direct control was widely discussed following the work of the fourth Working Party on financial stability in 1952. The findings of this group of eminent economists and financial experts, who met under the chairmanship of Professor Lionel Robbins, were published in August 1952.[2] In their report, the experts criticised several countries for making inadequate use of monetary measures to combat inflation after the war, and suggested that with the return to more normal conditions, the

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1. *Op. cit.*, paragraph 58.
2. *The Internal Financial Situation in Member and Associated Countries*, Report by a Group of Independent Experts, O.E.E.C., Paris, August 1952.

greater flexibility of these measures often gave them an advantage over fiscal measures and direct controls. These conclusions gave rise to some controversy at the time, but they pointed in the direction towards which policies have since moved. In October 1952, the Temporary Committee of Ministers, which had been appointed to examine this report in the light of detailed comments submitted by Member governments, reported to the Council that while it was clear that different policies were appropriate according to the situation faced by each individual government, there was agreement that undue reliance on direct controls could introduce rigidities into the economy and that both fiscal and monetary policy have an important part to play in the maintenance of stability.

Since 1952 there has been a change in the procedure for the examination and discussion within the O.E.E.C. of the internal financial situation in Member countries. This work is now incorporated in the regular annual review of the economic and financial situation in Member and Associated countries carried out by the Economic Committee (described in Chapter II). The same subject also figures prominently in the discussions of the group of high level economic experts which meets perodically to examine current economic developments. In addition, the Managing Board of the E.P.U. deals with the problem of financial stability when — as it often does — it impinges on international payments.

From 1953 until the middle of 1955, Western Europe as a whole achieved both a rapid rate of economic growth and a considerable degree of price stability. Although there were wide variations between different countries, the average annual increase in overall prices over the three years was 1.6 per cent, compared with 1.0 per cent per year in the United States. In 1953 and 1954 the main expansionary element was the rapid increase in house-building, but this was soon supplemented and surpassed by a general investment boom covering all types of capital formation. This upsurge in investment demand was facilitated by tax incentives which had been widely introduced during the post-Korean setback, by the generally low level of interest rates then prevailing, and by the fact that in several countries industrial concerns still had large holdings of liquid assets. But the real driving force behind the expansion was the renewal of business confidence. The successful recovery from the setback in Europe in 1952, and the small size of the down-turn in the United States in 1953-54, both contributed to dispel the lingering fears of a major post-war slump, and to encourage investment planning on the basis of continuous expansion.

In some countries, however, price increases during 1953 and 1954 were by no means negligible, and by the second half of 1955, it was becoming clear that over a wide area demand was outpacing supply. A shortage of steel developed in several countries, coal imports from the

United States rose rapidly, and there were signs that a new stockpiling boom was under way. Most important was the shortage of labour. Outside the Mediterranean countries, almost all available labour reserves had been drawn into employment. Further increases in output could come only from increased productivity — and productivity gains were becoming less easy to achieve as production reached the limits of capacity

CHART 17

War-time financing led to a rapid increase in money supply in almost all countries.

Consequently, where prices had been fairly effectively controlled during the war, a great deal of excess liquidity existed. In the absence of drastic monetary reforms, this excess was only slowly reduced as prices and production rose and the expansion of money supply was kept in check.

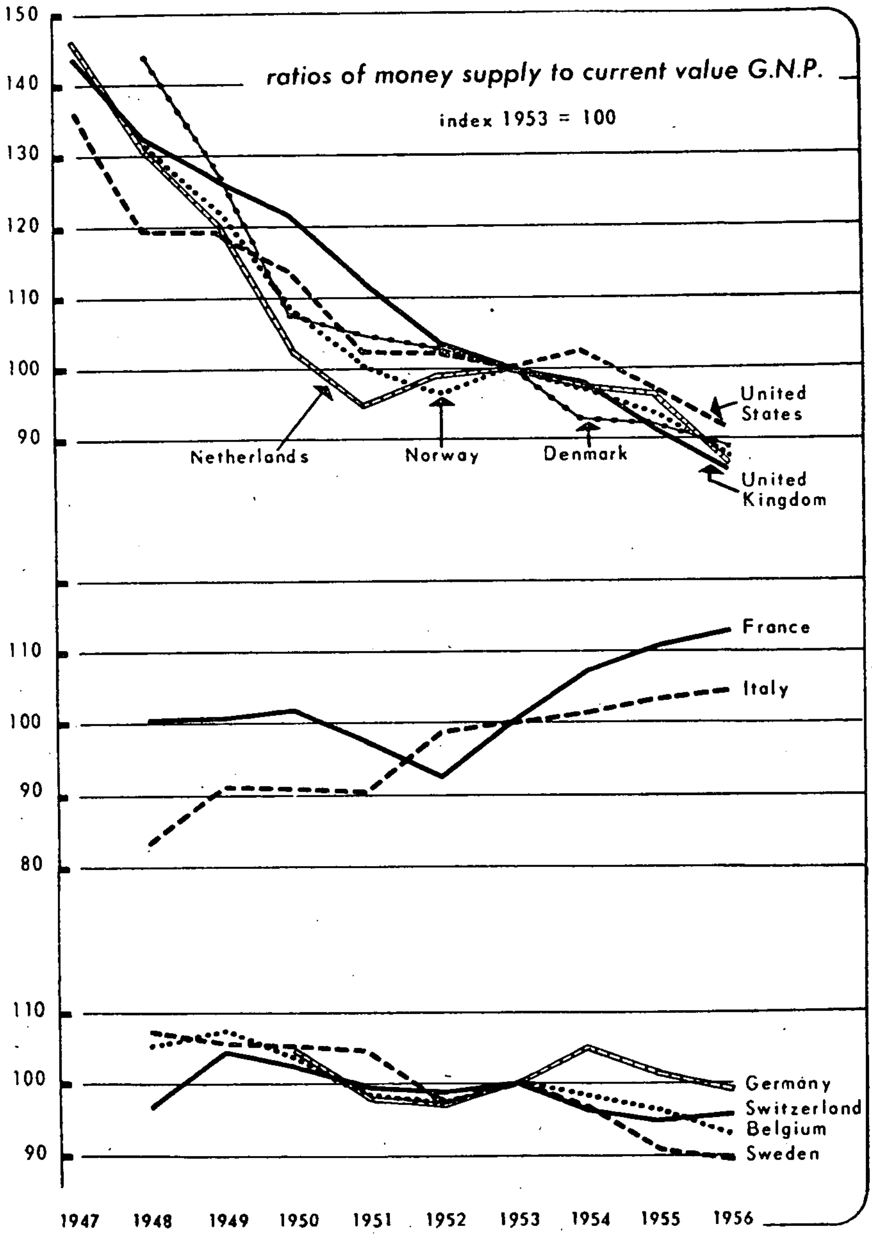
In Italy and France, by contrast, prices were rising freely up to 1947 and with confidence in the national currency greatly undermined, money balances had been run down to levels low in relation to current expenditure. As inflation was brought under control and confidence returned, money balances were rebuilt and the liquidity ratio rose — though this process was interrupted during the Korean crisis.

For a third group of countries, the expansion of money supply has kept in step with the current value of G.N.P. In Belgium and Germany, important post-war monetary reforms reduced excess liquidity and were followed by tight monetary control. In the non-belligerent countries, the war-time monetary expansion was smaller and the problem of excess liquidity has accordingly been less acute.

in one industry after another. A new period of inflationary pressure was the result.

In contrast with the earlier post-war period, the origin and nature of the inflationary pressures which developed varied considerably from country to country. In many countries the concentration of increased demand on certain specific sectors, notably machine tools and construction,

money supply in relation to output



led to sharp price increases in these industries. In the building industry, in particular, the pressure of demand led to a considerable rise in prices in several countries. Another factor which was important in a number of countries was the continuing increase in public expenditure, both on goods and services and in the form of transfer payments. This was specially important in France where increasing government expenditures in Algeria added to inflationary pressure.

In the absence of corrective measures, the combination of labour shortages and excess demand inevitably led to wage-price increases. In a few countries, however, there was some tendency for autonomous increases in unit labour costs to contribute more directly to the rise in prices. In these countries the fight to protect living standards against rising prices during the preceding inflation had led to the emergence of an established pattern of negotiated agreements, and had accustomed wage-earners to large and regular increases in money wages. During 1953 and 1954, substantial increases in wages did not generally put pressure on prices, partly because of the rapid increase in productivity, and partly because lower profit margins were offset by larger sales. But when the increase in productivity and output began to slacken off, wage increases of the same order of magnitude led to a rise in unit labour costs. Given the general inflationary climate, these increased costs were rapidly passed on to the consumer in higher prices.

The major reason for the difference in timing and strength of inflationary pressure in different countries was that some countries acted more quickly and effectively than others to bring it under control. Apart from the early removal of special incentives to investment in a number of countries, the initial reaction to the re-emergence of inflation was largely confined to monetary measures — in particular, the raising of the discount rate and credit restrictions. In several cases the rise in interest rates was fairly limited, and, in any case, while prices were rising and expectations of profits were good, the increased cost of credit did not have a very marked effect on demand. More direct measures designed to control or reduce the money supply by reducing the liquidity of the banks and limiting their advances were more effective, but in several countries the influence of these measures was less than was expected because liquid balances were still well in excess of minimum requirements in many parts of the economy. The most noticeable effect was on house-building and the purchase of consumer durables, where the rise in interest charges and special restrictions on consumer credit proved to be effective. During 1956 and 1957, monetary measures were supplemented in several countries by increased taxes, reductions in government expenditure, and in some cases price controls were re-imposed as an emergency measure. Nevertheless, although in several countries the growth of output slowed down considerably, prices continued to rise and, in addition, disparities in the balance of supply and demand in different countries led to growing imbalances in intra-European payments.

On July 16, 1956, the Council of the Organisation expressed its concern about the financial and trade aspects of the current economic situation and set up a Ministerial Working Party to examine the position. This Working Party met during the second half of November. In its report it noted that in some cases further improvements were needed to make monetary measures more effective, and stressed the need to accompany them by fiscal measures where they proved to be insufficient to reduce particular sectors of demand to the desired level. Special attention was paid to the large imbalances within the E.P.U. which the Working Party regarded as very serious. Recognising that these developments reflected divergent movements in national price levels and variations in the balance between supply and demand in different countries, separate recommendations were made to debtor and creditor countries ; in particular to France and the United Kingdom as the two biggest debtors, and to Germany as the biggest creditor.

The Suez crisis at the end of 1956 added to the balance of payments difficulties of some countries and led to some, mainly temporary, increase in the price of imported materials. During 1957 considerable efforts were made along the lines recommended by the Working Party. In many countries the rise in prices slowed down and in the latter part of the year current surpluses and deficits in the E.P.U. were reduced. Nevertheless, in France foreign currency reserves were nearly exhausted and there was a sharp rise of prices, while in several other countries the increase in output slowed down or stopped. Furthermore, the extreme cumulative creditor and debtor positions built up within the E.P.U. have not yet been reduced to any considerable extent.

In recent months the growth of total demand — and particularly investment demand — has slackened off over a wide area of Western Europe. Although price rises are still in evidence, there are now few signs of inflationary pressure in most countries. Restraining measures have been relaxed in some countries, while in others a shift of emphasis to policies that would encourage renewed expansion is being delayed until there has been a more substantial improvement in their external financial position. These problems are discussed further in Chapter VIII. What is pertinent here, is that events during the last two years have demonstrated more clearly than ever how closely national financial policies are linked with one another through the mechanism of the balance of payments ; if any one country fails to control inflation — or, on the contrary, pursues unnecessarily restrictive policies — the task of other countries in maintaining stability is made that much harder. Furthermore, it is apparent that the varying degrees of success in maintaining internal financial stability have been due partly to differences in the timing and vigour of the measures taken by each government. There is, therefore, a growing feeling that the procedure for consultation and discussion of fiscal and monetary policy will have to be strengthened in order to achieve a more effective co-ordination of national policies.

ELEMENTS OF INFLATION AND THEIR SIGNIFICANCE FOR ECONOMIC RECESSION*

The year 1957 marked another turning point in the curve of economic growth traced by the developed countries during the nineteen fifties. The post-Korean expansion, which had already been proceeding at a decelerating rate in 1956, lost most of its momentum in the course of the past year. In North America the rate of economic activity levelled off early in 1957 and began moving downwards during the latter part of the year, Although in western Europe the average level of economic activity was still higher than a year earlier, in a number of countries end-year output fell below the beginning-year rate; and, as had already happened in the United States, burdensome surpluses and excess capacity were beginning to appear in 1958 even in sectors of the economy which had once been disturbed by equally troublesome shortages.

At this writing it is still too soon to foresee how far the recession may develop or how long it may last. There is no question of the recession taking on the dimensions of the pre-war depression; a decline on any such catastrophic scale is inconceivable, on social and political, as well as on economic, grounds. Despite the current downturn in business plans for investment, confidence in the longer run built up by a decade of continued economic growth remains unshaken. Major institutional changes in all industrial countries have both lessened their instability and strengthened their resistance to shock. Banking and other financial institutions, which proved most vulnerable to cyclical downturns in the past, have been immeasurably strengthened. Speculative excesses, which historically triggered many of the reactions from boom to collapse, have also been more successfully controlled during the recent expansion phase. Of more immediate significance is the vastly enlarged role of the government budget in the national economy. Though the longer-term implications of the expanded share of government in private enterprise economies may remain in dispute, there can be little debate over its short-term stabilizing influence. The relatively high post-war level of government spending, determined independently of market conditions and subject more to counter-cyclical than to cyclical forces, supplies an important element of stability in national expenditure that was not available in the nineteen thirties. At the same time, the more than proportionate change in tax yield than in national product, associated with steep post-war income tax rates, provides strong support for private income after tax in relation to output. In addition, a number of built-in stabilizers, developed during the nineteen thirties and the war period—most notably, regardless of imperfections, the programmes for unemployment compensation and for sustaining farm incomes—impart a powerful braking effect on the rate of decline in

*World Economic Survey, 1957, United Nations, 1958, pp. 3–9, 60–62.

economic activity. These elements have already provided their effectiveness in the past and they are undeniably of great significance in slowing down the current recession.

If a depression on the scale of the nineteen thirties need not be feared, however, neither may it be anticipated that in the United States—the country with maximum impact on the world economy—the recession will be as brief or as mild as in 1948/49 or 1953/54. The decline in its industrial production and the rise in its unemployment, indeed, already exceed those of the previous two downturns. Early in the recession attention was naturally focused on the large-scale reversal from accumulation to liquidation of inventories which has characterized all three post-war downturns. It was hoped that under the influence of favourable long-term economic trends the economy would right itself once again when excess inventories had been worked off; liquidation would then cease and give way to renewed stock-building. It has become increasingly evident, however, that despite the vastly expanded economic horizons and the firm confidence in the longer term, expectations of the rate of growth of demand in relation to capacity in the intermediate range are being revised downwards. With excess capacity having been built up for some time in many lines of industry, business plans for plant and equipment expenditure have been cut back significantly; given the time which must necessarily elapse before plans materialize, the full effects of these cuts may not be felt until 1959. The situation in housing and in consumer durables is also much less favourable than formerly; in both earlier recessions, residential construction and consumer outlays on durable goods, especially automobiles, paced the recovery and gave new impetus to business plans for investment, but in the recent phase these two industries have been among the first to become depressed.

Not least of the striking features of this recession is the apparent suddenness with which it came on the scene. As late as the summer of 1957 the overriding concern, both inside and outside the United States, was the problem of continuing inflation. This is reflected, among other things, in the debate of the Economic and Social Council at its twenty-fourth session in mid-1957 and its resolution requesting the Secretary-General to study the subject of inflation in the present *Survey*. In the United States, though seasonally adjusted unemployment at the time of writing, in May 1958, was estimated at a post-war peak, carry-overs of earlier fears of inflation remained a major factor in the hesitation to counteract the recession through a reduction in taxes or through an increase in the government budget, as distinct from acceleration of already approved public expenditure. Production trends in many western European countries early in 1958 were reminiscent of those a year earlier in the United States; the boom of the preceding years had lost its momentum, and in very few instances was output significantly higher at the beginning of 1958 than a year earlier. Economic policy in western Europe, nevertheless, continued to be influenced by fears of inflation.

The ending of the boom in western Europe and the beginning of the recession in North America will be examined in some detail in part II of this *Survey*. It needs also to be considered, however, how it may happen that a situation so widely characterized as inflationary should suddenly be threatened by deflationary forces. Did circumstances change so suddenly, or may preoccupation with inflation have obscured elements of deflation that were present all along? If so, what sort of inflation was it that it could coexist with powerful deflationary tendencies? Part I of the *Survey*, which, at the request of the Economic and Social Council, is devoted to a study of inflation, addresses itself in large part to this question.

The Recent Inflation in Industrial Countries

It is probably no exaggeration to say that the world has never been so acutely sensitive as in recent years to the dangers of inflation. Nearly a generation of experience with the social and economic costs of war-time and of post-war inflation seems to have transformed the economic psychology of the world community; old fears of depression and mass unemployment apparently gave way to new anxieties over wage-price spirals and erosion in the value of money. These anxieties did diminish for a time with the growing liquidation of the acute inflationary pressures of the early post-war years; indeed, during 1948/49 even more than in the past year world concern was centered not so much on the remaining pockets of inflation as on the international impact of a recession in the United States. The outbreak of Korean hostilities generated a new shockwave of inflation, however, and long before the new military plans could be translated into higher actual outlays, the world witnessed a boom in raw materials' prices of extraordinary proportions.

The boom collapsed soon after it began when the true economic dimensions of the Korean struggle became evident. For a short while it seemed that inflation would revert to the status of a local phenomenon, confined primarily to countries with a long history of continuing inflation. This expectation did not materialize, however. After a year or more of comparative stagnation, western Europe embarked in 1953 upon a period of vigorous economic growth. Welcome as was this expansion, it was soon accompanied in most countries by mounting concern over inflation. After its mild recession in 1953/54, the United States likewise entered upon a phase of rapid expansion, which, though of shorter duration than in western Europe, generated no less acute fears of inflation.

Paradoxically, the inflationary developments which gave rise to such widespread anxiety were of relatively modest proportions. Neither at the wholesale nor at the consumer level were the price increases comparable with those of the Second World War, the early postwar years or the Korean boom; indeed, the increases in wholesale prices were not as large as those which had accompanied the recovery from the depths of the depression in the nineteen thirties. Nor was the pattern of price increases typical of earlier periods of inflation; whereas normally prices of raw materials tend to rise relatively sharply under the pressure of demand, during this period significant increases were confined to a limited group of commodities. Farm food prices were notable for their weakness; so much so that several countries had to consider measures to bolster farm prices, hand in hand with the tightening of general controls against inflation.

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That the modest and uneven character of the recent inflation in industrial countries was generally recognized is evident from the new term—creeping inflation—which was coined in order to distinguish it from earlier, more conventional types. The deep-seated concern reflected not so much the magnitude of the pressures, as the setting in which they appeared. Three successive bouts with galloping inflation—during the war, the post-war reconstruction and Korean hostilities—had conditioned the public to fear even creeping inflation, especially since its pace appeared to be accelerating rather than diminishing. Of greater importance, perhaps, was the fact that for the first time, inflation was not generated by the abnormal forces of war or of post-war readjustment but was associated instead with the normal forces of economic growth. In the context of a universal commitment to maintain high levels of employment and a post-war drive for rapid long-term growth, inflation appeared not merely as a passing danger but as a permanent threat to stability. Thus, even creeping inflation had to be resolutely avoided lest it gather momentum and develop into the galloping variety.

Concern over internal stability was prompted, in many instances, by anxiety over external balance. Even had countries been willing to overlook the effects of price increases upon the internal economy, they could not look with equanimity upon growing balance of payments deficits and dwindling foreign exchange reserves. These countries were the first to resort to restrictive measures; but since countries with surpluses in their balance of payments also felt obliged to impose anti-inflationary measures in the course of the expansion, such policies proved only of limited effectiveness in correcting the international imbalance.

What accounts for the apparently sudden economic reversal, beginning in mid-1957, from inflation to recession? Part of the explanation must be sought in the delicate balance which exists in a dynamic economy between inflation and deflation. Where advancing technology and high levels of investment constantly add to productive capacity and raise the average level of output per man, inadequate demand cannot be automatically equated with falling demand. Even a rising demand may prove inadequate to provide for full employment and full utilization of capacity. A problem of inadequate demand may thus develop while output, employment, incomes and profits are still increasing. It is true that even under such conditions symptoms of inadequate demand might emerge in the form of involuntary accumulation of inventories, unutilized capacity and growing slack in the labour market. But it is not easy to judge from recorded statistics whether the rate of inventory accumulation is voluntary or not, or whether capacity is excessive in relation to the potential rate of growth of demand; nor, in view of a widespread tendency of management to "hoard" labour during a period of growth, no data on unemployment provide a sensitive indicator of adequacy of aggregate effective demand. Psychologically, too, it is difficult to become aroused over unutilized capacity while profits are still rising, or concerned about developing slack in labour markets while employment is still increasing; in a word, it is hard to be pessimistic about demand while the economy is still climbing. Experience with each of the post-war recessions shows that it is all too likely instead that anxiety over inflation may persist for some time after the economic trend has already been reversed.

The possibility of a sudden shift to deflation is all the more likely when the inflation is of the creeping variety. It is not simply that creeping inflation involves a relatively minor degree of excess demand, so that a policy for its elimination may introduce a deflationary bias in the economy. Perhaps of even greater importance is the fact that creeping inflation tends to reflect mixed pressures, excess demand in one sector coinciding with excess capacity or surplus stocks in other segments of the economy. In an economy where inflation exists side by side with elements of deflation, exclusive concentration on the problems of rising prices may be especially hazardous.

In the traditional body of economic literature the possibility of mixed inflation does not seem to have been discussed; it seems universally to have been concluded that inflation is necessarily the result of a general excess of demand. This conclusion follows understandably from the classical assumption of a perfectly competitive market in which prices and wages are continuously adjusted so as to eliminate any excess demand or excess supply. In such a market, if there is no excess demand (or supply), prices will come to rest; if, therefore, prices are rising cumulatively, it can only be because excess demand is constantly tending to reemerge. The question as to whether inflation necessarily reflects a general excess of demand arises only because in the real world prices and wages are not always set so as to clear the market. They may be set, instead, at levels at which demand in some markets exceeds, and in others fall short of, supply. Needless to say, this does not imply that prices and wages are set without regard to demand and supply conditions—it only means that other considerations also enter into their determination. These considerations include conventional pricing formulae, collective wage-bargaining and government regulation. The direct links between prices and wages through such arrangements may frequently be stronger than any indirect links via demand and supply relationships. Prices may be set by adding a percentage markup over unit labour and materials costs; wage bargaining may be linked to the cost of living; and government regulations, especially of farm prices, may be designed to maintain some form of parity between prices received and prices paid by farmers. Because of these interlocking relationships, any demand or supply factor tending to raise prices or wages in important markets or any independent move by a major income-earning group to raise its earnings, may easily touch off a chain reaction leading to a cumulative wage-price spiral.

Under such circumstances, it is clear, inflation cannot be automatically equated with an excess of aggregate demand over supply; it cannot be defined as necessarily standing at the opposite extreme from depression. Though analogies are never sufficiently precise, it may be helpful instead to compare inflation with unemployment. Just as unemployment may result not only from inadequate aggregate demand but also from certain structural features of the economy, so a cumulative rise in prices may be generated not only by excess aggregate demand but also by certain structural features of the pricing mechanism.

Naturally excess aggregate demand remains a major source of inflation, just as inadequate demand is a primary cause of unemployment. But just as unemployment may also arise from seasonal and frictional factors associated with the difficulties of transferring labour from one job to another without any general deficiency of demand, so inflation may result from bottlenecks in productive capacity in some industries without any general excess of demand. Management may feel encouraged to raise profit margins and trade unions to press for higher wages in industries experiencing excess demand. And the increases may spread, in accordance with prevailing price and wage patterns, to the rest of the economy, even where demand may not be sufficient to absorb the available supplies or productive capacity.

Moreover, a wage-price spiral need not originate only from a general or partial excess of demand over supply or productive capacity; it can be touched off whenever demand is sufficiently buoyant to prompt labour or management to press for higher wages or higher profit margins. Demand need not, in fact, be rising significantly everywhere; increases in earnings rates in key industries may release the catch to set off a wage-price spiral throughout the economy. It is not even necessary for prices in the key industries to rise more than, or indeed as much as the average level; increased productivity may partly offset higher wages and higher markups in the sectors benefiting from expanding demand. Wage rates are also likely to be increased in other parts of the economy, however, where they cannot be absorbed as readily by advances in productivity, so that prices elsewhere may rise to a greater extent than in the key industries.

Unfortunately, once a wage-price spiral sets in, it may continue to advance long after every trace of rising demand has disappeared; indeed, as current experience in the United States amply demonstrates, even well into a period of recession. In the light of this experience there can be little doubt that inflation, like unemployment, may be of a "structural" character, not too closely dependent upon the adequacy of demand in relation to productive capacity. Just as unemployment may stem from a lack of adequate productive capacity, rather than of effective demand, so cumulatively rising prices may stem from excessive claims for higher incomes rather than from an excess of demand for goods and services. And though the intensity of pressure for higher incomes may be expected to vary with the pressume of demand for goods and services, the relationship is hardly so close that a wage-price spiral may be taken as sufficient evidence of excess demand.

The recent inflation developed in association with a boom which began in demand for consumer durables and housing and spread to private investment in plant and equipment. In the investment goods industries there can be little doubt that, in a number of countries, some excess demand did develop for a time; new orders for durable goods outstripped deliveries, order books lengthened, and productive capacity in some industries was strained. With an important sector of the economy exhibiting such symptoms, concern over inflation tended to focus on excess demand as the primary cause. This was all the more true since unemployment was generally low and national income and production were increasing. Given the high level of aggregate activity and the symptoms of demand pressure in a segment of it, the distinction between high levels and excessive levels of aggregate demand tended to be blurred. The illusion was created that if prices are rising throughout the economy, the economy as a whole must be experiencing an excess of aggregate demand. And as price increases continued to spread and even to accelerate, less and less importance was attached in this context to the evidence of mounting surpluses of food and agricultural raw materials, or of the long-standing excess capacity in textile industries; even the significance of the subsequent decline in demand and the emergence of excess capacity in consumer durables, in housing and in related industries which had initially sparked the boom, tended to be overlooked. Though demand was falling ever more short of productive capacity, economic policy continued to concentrate on restraint of demand for curbing the upward movement of prices.

THE NATURE OF RECENT ANTI-INFLATION POLICY

The policy of industrial countries for curbing inflation in recent years presents a striking contrast with that generally employed in the war and even the early postwar years. The most notable difference lies in the elimination of direct market controls; apart from one or two instances, anti-inflationary policy has been limited to measures of a general and indirect character. This shift towards an essentially free market economy had already been largely completed by 1950, although controls on foreign trade, in most countries, were relaxed more gradually. During the Korean hostilities the only important instances of direct controls for curbing inflationary pressures were the revival of machinery for international allocation of strategic raw materials and the re-introduction of moderate price-wage controls in the United States.

In the recent phase of expansion there could be no question of suppressing an excess of aggregate demand by means of direct controls, since demand pressures were not even remotely comparable in magnitude to those of the war or early postwar years. Though the expansion was based on a boom in investment which for a period strained the capacity of some industries, its inflationary effect was in part offset by mildly deflationary government budgets, and in part mitigated by means of foreign trade. With residential construction also coming to be widely discouraged in the course of the boom, only in a few countries was the pressure of demand for saving to finance domestic and foreign investment and budget deficits appreciably higher than during the first year of Korean hostilities; in many cases pressure was lower. In some countries the growth of productivity and income was accompanied, moreover, by a rising proportion of income which people were prepared to save, particularly as their demand for consumer durables slackened. In the event, therefore, the supply of saving proved adequate to satisfy the demand without far-reaching government intervention.

Perhaps a more striking feature of recent anti-inflationary policy is the shift in emphasis from fiscal to monetary measures. After a revolutionary development during the war, fiscal policy became relatively passive in the nineteen fifties, and monetary policy gradually assumed the major active role in dealing with the new inflationary tendencies. This shift represented a social, as much as an economic, phenomenon.

Though outright intervention in the market-place had been eliminated, government participation in economic life remained far more important than it had ever been in peace time, government budgets absorbing from 20 to 30 per cent of the national product in nearly all industrial countries. Given the growing public impatience with the high post-war taxes necessary to finance this enlarged share, an increase in taxation would have met with widespread disfavour as an anti-inflationary weapons. Even in countries experiencing balance of payments crises there was evidently a firm determination to avoid any increase in levies on personal incomes. At the same time requirements for national defence remained high, while budgetary obligations incurred as a result of the Second World War, together with pressing social and economic needs, made it impossible to moderate inflationary pressures by significant cuts in civilian government expenditure. Increasingly therefore, the centre of gravity in anti-inflationary policy shifted from the fiscal to the monetary zone.

These considerations found much of their economic support in the thesis that inflation is caused ultimately by "too much money chasing too few goods". The fact that price increases involve a greater rate of increase in the flow of money expenditure than in the flow of goods was widely taken to justify a policy of preventing inflation primarily by measures to restrict the flow of money. Since this flow is the product of the quantity of money times the velocity of its circulation, and since the velocity is largely determined by institutional forces which cannot be readily curbed in a period of rising prices, it was the quantity of money which emerged as the strategic factor for controlling inflation. Accordingly, the supply of credit was severely restricted and the rate of interest was raised to the higest levels since the nineteen thirties. A complex set of credit controls was developed, including, in addition to traditional open market operations and higher discount rates, variable reserve requirements, penalty rates on excess borrowing from central banks, and in several instances outright prohibition of any increase in lending.

There is little doubt that a policy of restriction of bank credit, if pursued with sufficient vigour, can succeed in reducing the flow of money outlays on goods and services. The evidence on the efficiency of the monetary measures during the recent expansion in industrial countries is not entirely persuasive, however. It is true that selective credit controls contributed significantly towards restraining expenditure on consumer durables and on residential construction. These restrictions were reinforced, however, by other government measures, including indirect taxation on durables, withdrawal of housing subsidies, and, in the United States, the maintenance of non-competitive rates on government-insured mortgages; moreover, at least part of the decline in demand in these industries may have been a natural reaction to the earlier boom. The efficiency of the general, as distinct from selective, credit controls during this period, it will be seen in chapter 1, is open to greater doubt. It is noteworthy that the recent boom was accompanied by a relatively moderate rate of inventory accumulation; but the significance of credit policy in this respect must be assessed in the light of the impact of other factors such as food surpluses, relatively depressed textile industries, and reduction in government stockpiling of strategic raw materials. The effect of monetary policy on business investment in plant and equipment is even more difficult to evaluate, particularly since investment in plant and equipment actually rose in relation to consumption in most of the industrial countries.

Credit restrictions, though they did not reduce the absolute level of business investment demand, may have retarded its rate of growth—if not directly, at least indirectly through the damping of business expectations. This effect was evidently subject to a considerable time lag, however. It is true that monetary restraints compare favourably wth fiscal measures on the grounds of administrative flexibility and timing; whereas fiscal changes can be made only through relatively slow legislative processes, monetary measures may be altered by the central authorities as frequently and as rapidly as circumstances seem to warrant. In practice, however, this important advantage may be offset by a long time lag between monetary restrictions and their impact on actual expenditure for goods and services. In contrast to the direct links between private income and expenditure, the links between central bank operations and expenditure may be long and roundabout. Despite increasing stringency of credit controls, the monetary authorities generally did not prevent an expansion of bank advances during the recent inflation; in most instances, only the rate of growth in bank credit was reduced. Banks sold government bonds at a loss and borrowed at rising rates in order to obtain funds for more profitable bank advances. Moreover, the authority of the central banks over credit is far from comprehensive; in periods of credit restriction other financial institutions and even business corporations tend to supplement the credit operations of the banks. In addition, business generally tends to reduce its liquidity requirements so that restrictions on the quantity of money are partly offset by increases in its velocity of circulation. Given the inherent instability of investment demand, the danger cannot be overlooked, therefore, that central-bank policy may produce its maximum restrictive effect, not when investment demand is strongest and may need to be curbed, but only after plans have already turned downwards and need to be stimulated.

No less important than the effect of monetary policy upon the flow of expenditure is the effect of changes in this flow upon price movements. When the disparity between the flows of money expenditure and of goods and services reflects an excess of aggregate effective demand over productive capacity, a reduction in money outlays, whether it be achieved through monetary or through fiscal restraints, is an appropriate means of curbing inflationary pressure. It may then prevent cumulatively rising prices by eliminating excess demand without an adverse effect on production and employment. When, however, demand pressures are of a mixed character, with rising prices and wages generated in a sector experiencing excess demand spilling over into other sectors characterized by excess capacity, a policy of generalized monetary restraint may prove an inefficient weapon for coping with the inflation. Such a policy may, it is true, release resources from industries where pressure of demand is relatively low to those where it is relatively high. Its effectiveness in this respect is far from certain, however, particularly if investment is the sector with excess demand and consumption the sector with excess capacity; by curbing demand where capacity is ample, the restraints may then increasingly discourage expansion of capacity where it is inadequate. Thus, the growing slack in consumer goods industries may in the end adversely affect investment demand itself, the result being that even capital goods industries suddenly find their fortunes reversed, with excess capacity replacing excess demand.

Monetary policy may be even less efficient in halting inflation when the excess money flow is the effect rather than the cause of the wage-price spiral. This is the case, for instance, when the demand for credit stems not from pressure of excess demand for goods and services against total productive capacity but from labour pressure for higher wages or business decisions to raise profit markups. Monetary restrictions may not then prevent labour and management from setting higher wage bargains or profit markups; they may instead lead to a reduction in effective demand for goods and services below productive capacity. In so doing they may even slow down the rate of growth in investment and in average output per man, thereby raising costs of production and imparting another upward twist to the price spiral. Output and employment may thus fall significantly long before the wage-price spiral can be brought to a halt.

Many have hoped that the pressure of labour and business for higher earnings rates might be weakened by a policy of credit restriction even while output and employment continued to grow. Virtually all governments have resorted to exhortation to both labour and business to moderate their demands. In the absence of national wage-price policies, however, it is only natural that individual unions and corporations should seek to maximize their earnings—no labour union or business corporation can afford to lag behind the others in protecting its interests. This poses a fundamental dilemma for the industrial countries: how to reconcile rapid economic growth with price stability under conditions of minimum interference with the market mechanism for the allocation of resources.

It has not been an easy task to face up to this dilemma; it is never pleasant to discover that goals which have been regarded as absolute may not always be mutually consistent but may need instead to be harmonized and accommodated to one another. The very complexity of the challenge posed by this dilemma may have contributed in some measure to a tendency to minimize it or even to deny its existence. Thus it has been frequently assumed that the ultimate cause of inflation is in all instances an excessive flow of money expenditure and this excess has often been equated with an excess of aggregate effective demand over productive capacity. Were inflation necessarily the converse of depression—were cumulatively rising prices always the result of an excess of total demand, just as industrial depressions are the result of a deficiency in demand—there could of course be no conflict between the goals of economic growth and of price stability. Fiscal and monetary policy designed to maintain a proper balance between the rates of increase of effective demand and of productive capacity would then simultaneously ensure both maximum production and price stability.

Unfortunately, though a disparity between the flows of money expenditure and of goods is a necessary symptom, it is not always the ultimate cause of an inflationary process. Regardless of origin, rising prices must take the form of a higher rate of flow of money than of goods, and an excessive money flow of expenditure may be a result just as often as it may be a cause of rising prices. Once it is recognized that inflation is not solely a question of balance between aggregate demand and productive capacity, but that it depends also upon demand pressures in particular sectors of the economy and especially upon the pressure of competing groups for higher earnings, it will be seen that fiscal and monetary policy may not always be capable of ensuring the restraints on demand may not succeed in achieving price stability Thus, in the face of excessive claims for higher incomes, generalized restraints on demand may not succeed in achieving price stability except at the expense of permanently curbing the rate of growth—indeed even at the expense of introducing higher levels of unemployment than the economy is prepared to accept. With the recession developing in North America and the expansion grinding to a halt in much of western Europe, this dilemma has been coming into increasingly sharper relief.

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CONCLUSION

Price increases in industrial countries in recent years cannot in general be attributed to an excess of aggregate demand. Even during the period of greatest pressure of demand, most sectors of the economy other than those producing durable goods had surplus capacity, and could have increased output significantly in response to higher demand.

It is true that unemployment was generally low during the period of greatest demand. But the demand for labour was not so strong as to prevent the service industries from continuing to increase their share of total employment. Moreover, the labour bottleneck was generally much less serious than it appeared from unemployment data because employers frequently preferred to hold on to their workers in the expectation of better economic conditions in the future rather than run the risk, by dismissing them, of subsequent difficulty in recruitment. Thus the slackness in demand for labour outside the durable goods industries was for some time expressed more in a fall in the rate of increase of productivity than in a growth of unemployment. In many countries, moreover, no significant shortage of labour occurred even at the peak of the boom.

Undoubtedly there was, in certain countries, considerable pressure of demand upon supplies of durable goods for investment and consumption. What happened, in effect, was that the pattern of demand for consumption and investment was substantially different from the pattern of supply of consumer goods and investment goods made possible at full employment by the existing distribution of productive resources. In other words, the community was demanding more durable goods than could be supplied, and could have supplied more by way of other goods than was being demanded.

Average prices generally moved approximately in line with the total of wage and materials costs. Examination of the period from 1950 to 1956 shows that wage costs in manufacturing were relatively stable from 1952 to 1954, and that they were not the most important initiating factor in the price inflation which began during the Korean conflict and which was due in the first instance to soaring costs of materials. The role of wage costs was probably much more important during the price inflation of 1955–1957, though even here part of the rise in wage costs represented a response to other factors, particularly autonomous increases in the cost of living brought about by such developments as governmentally administered changes in food prices, decontrol of rents, and the raising of indirect taxes or reduction of subsidies.

While, therefore, increases in wage costs are statistically the most important element in the price inflation over the whole period from 1950 to 1956, this fact cannot be interpreted to mean that the price inflation was always wage-initiated. On the contrary, it is only during a relatively brief part of the period, at the end, that increases in wage costs may have been the major causal element in price increases.

What is true, on the other hand, is that in modern times, especially in a full employment situation, the cost-price structure is generally in a position of unstable equilibrium, in the sense that it takes only a relatively small disturbance to move the whole system upwards. The most important element contributing to this situation is the cohesiveness of the wage structure, and the fact that variations from one industry to another in earnings are much smaller than those in productivity. Wages will not necessarily advance more rapidly than productivity if all other conditions are stable. But once anything happens to force up prices in a particular sector of the economy—such as a rise in the pressure of demand in the labour or product market in that sector—the whole economy is likely to follow suit. For if the rise in prices in the initiating sector is due to higher labour earnings, the rigidity of relationships among industries will mean that earnings in other sectors will follow suit, irrespective of whether productivity has also risen to that extent. And where the original price increase is due to higher materials costs, this too may set the system in motion through the effect on the cost of living and hence upon wage demands in general.

Moreover, so long as full employment is maintained, it cannot be expected that prices will ever fall appreciably, unless there is reason to expect a secular downward trend in materials costs dut to a more rapid expansion in the output of materials relative to manufacturing than has prevailed during the past twenty years, as a whole. There is no means of projecting past experience regarding commodity terms of trade into the future. What is clear, however, is that wage costs are not likely to decline very much so long as full employment is maintained. Consequently, each phase of wage-cost inflation starts out near the point at which the previous comparable phase left off. Any decline in wage costs in the interim is not likely to compensate fully for the increase in the upward phase if only because declines are not likely to spiral, whereas increases are. These, then, are the factors which give modern price inflation its distinctive characteristics, and which raise new problems for government policy.

Differences between countries in the pull of home demand have caused substantial swings in balances of payments. Where domestic demand rose most, balance of payments difficulties usually followed. It is not clear what part was played in this process by relative changes in domestic costs through their effect on export prices, but it seems doubtful whether this was a major factor during the period under review. Some of the balance of payments problems encountered were the result of the inadequacy of foreign exchange reserves for absorbing short-term speculative capital movements. This, however, was superimposed upon a deeper disequilibrium resulting from failure of countries to keep in step in the growth of internal demand.

The policies adopted to counter inflation were centered mainly on action by the monetary authorities to raise the cost and limit the quantity of credit. Only where balance of payments difficulties were experienced were taxes raised, and even here the increases were confined to indirect taxes, which tended to accelerate the price inflation, and corporate taxes, so as to reinforce the effects of the credit squeeze on investment. No government was prepared to curb demand by raising personal income taxes. Most governments did, however, slow down the rise in expenditures, or reduce special categories of expenditure, and this, together with the effects of progressive taxation in a period of rising incomes, gave a mildly anti-inflationary character to fiscal policy. Few countries engaged in any frontal attack on prices and wages.

The effect on economic activity of using interest rates and general restrictions on the availability of credit seems to have been limited by several factors. Higher interest rates did not prevent investment from rising and even accelerating, where business expectations were optimistic. The share of the banking system in the flow of funds to business enterprises was, in general, sufficiently small so that curtailment of bank credit could be offset by use of accumulated liquid reserves, by flotations on the capital market, or by resort to facilities of financial institutions other than banks. Even after a substantial period of credit restraint, there was no indication of any serious concern on the part of corporations that further industrial expansion might have to be limited because of inability to secure the necessary finance. It is, of course, possible that general credit policies may exert their influence primarily through their effect on business expectations, rather than through the cost or availability of credit. However, circumstances may be favourable for eliciting the desired response in one situation and not in another. Since in this and other ways psychological factors are notoriously hard to predict and to control, it was not unnatural that the policies pursued were uncertain in their impact.

Greater immediate results seem to have been secured by the use of selective credit controls to discourage housing and the purchase of consumer durables. There is some doubt as to how far the consequent relative decline in these sectors released resources which could be used elsewhere in the economy. In some countries, however, simultaneous fiscal and monetary restraints on the consumption of durable goods did contribute to an improvement in balances of payments.

It seems fairly clear that, except in one or two of the Scandinavian countries, the policies were not designed to adapt the pattern of demand to the pattern of output possible with existing resources. Since the aim was to limit total demand and not simply the demand for investment, industries operating with surplus capacity were bound to experience a drop in demand along with industries where capacity was currently inadequate. In most countries no attempt was made to devise a combination of fiscal and monetary policies which would restrain excessive demand for goods in short supply while increasing demand for other goods.

Much less success seems to have been achieved in controlling the rise in prices than in curbing the level of demand, in the course of the period reviewed.[1] The cost-price spiral acquired a momentum of its own and did not appear responsive, at any rate in the short term, to a slackening in demand. The data suggest, in fact, that in so far as the slackening of demand may have slowed down the growth in productivity more than the granting of wage increases, the restrictive policies may even have had some perverse effect on cost inflation.

Inasmuch as the balance of payments difficulties of a number of industrial countries occurred at different points of time, the relatively greater restraint in domestic demand introduced in these countries was sufficient to arrest further deterioration in their external positions. There is, however, little evidence that individual governments took the situation of other countries into account in determining their own economic policies. The opposite movements in bank rate in the Federal Republic of Germany and the United Kingdom, in September 1957, seem to have been virtually the only instance of concerted action, and even this cannot be regarded as having a very powerful effect on disequilibrium within Europe. In this sense the world economy seems to operate with even less efficiency than under the nineteenth-century gold standard. In those days, governments which "played the game according to the rules" were expected to allow the internal supply of money to rise in response to an increase in the export balance, financed by an inflow of gold, and to fall in the opposite case when gold flowed out. There is room for argument as to whether changes in the supply of money were in fact the most important equilibrating forces in the nineteenth century. But it is in any event clear what the intention of the system was—namely that surplus and deficit countries should participate equally in the mutual adjustment of their balances of payments.

In modern times the domestic economy is to a considerable extent insulated against foreign disturbances and none of the creditor countries in the recent past has taken an increase in the export balance as a signal for raising the level of internal demand; indeed, the largest European creditor sought to offset the effect on domestic demand of its large unintended export balances. Thus the burden of correcting international disequilibria has not been shared between surplus and deficit countries; rather, the degree of deflation required in the deficit countries has been increased by the limits placed on demand in the surplus countries. This has inevitably introduced a significant deflationary bias into the process of international balance of payments adjustment.

The most important issue raised by recent experience in the industrial countries, however, relates to the implications of restrictive policies for long-term growth. Since price increases during the recent boom were not due to an over-all excess of demand, it could not be expected that they would be particularly sensitive to measures de-

[1] The Norwegian Government, Central Bureau of Statistics, in *Okonomisk Utsyn Over Aret 1957* (Economic Survey for 1957) (Oslo, 1958), states that "It seems quite clear that the better balance between supply and demand attained during the last few years has been practically without effect on the development of wages. This is an experience Norway shares with a good many other countries".

signed to restrain the growth of demand. Thus prices continued to rise when the rate of business expansion slowed down and even, in some cases, when production began to fall. Under such conditions, which are typical of modern times, attempts to secure price stability through curtailment of demand may not be able to stop short of bringing any advance in economic activity to a standstill if the objective is pursued vigorously. At the very least, such policies may necessitate a rate of growth much slower than that to which the post-war world has become accustomed. Moreover, in so far as sectoral excess demand has to be eliminated without any attempt to match the pattern of resources with the pattern of demand, the degree of utilization of labour and capacity in the economy as a whole may also have to be substantially lower than in the recent past. Even if such policies can be implemented successfully without the danger of sliding into a serious downturn in economic activity—which is far from certain—they raise the gravest questions for governments regarding the various economic goals which they wish to pursue, and the balance that they wish to strike between these goals.

BELGIUM

CENTRAL BANKING IN BELGIUM*

1. Historical Setting

From the fall of the French Empire (in 1815) until 1830, Belgium was part of Holland. To promote the establishment and use of fiduciary money in Belgium, King William of Holland created at Brussels in 1822 the "General Society for the Promotion of National Industry," with a limited right of note issue; and for three years after Belgium became independent of Holland in 1830, the Société Générale remained the only bank of issue in Belgium. Owing to difficulties between it and the Belgian Government, the latter, in 1833, established the Bank of Belgium, with the right of issuing notes to the amount of its capital. Competition between the two banks became intense; and the combination of excessive lending by both, and the run on banks caused by the French Revolution of 1848, produced crises for both institutions in that year.

The need for a change became evident; and as a result mainly of the initiative of the Minister of Finance, Frére-Orban, the National Bank of Belgium was created by law on May 5, 1850, with a capital of 25 million Belgian francs ($5 million), and a 25-year franchise. While the law did not endow the bank with a monopoly of note-issue, the privilege was never subsequently given to any other bank; and that of the National Bank of Belgium was successively renewed. In participating in the capital of the National Bank the *Société Générale* and the Bank of Belgium agreed to withdraw their notes from circulation.

On the whole, the formal status of the National Bank was little changed until 1948. (See below.) There was, however, a gradual evolution—speeded up in the 1930's—both in the Bank management's conception of the nature of its task, and in public awareness of the important role of the central bank in the broad task of economic stabilization.

2. Ownership and Control of the Central Banking Institution

From its founding in 1850 until 1948, the National Bank of Belgium was privately owned. The law of July 28, 1948, which strengthened the government's control over the Bank, provided, *inter alia*, for an increase in the Bank's capital from 200 million (a figure to which it had been gradually increased from its initial capital of 25 million in 1850) to 400 million Belgian francs, of which half would be subscribed by the government.

*Prepared at the request of the Joint Economic Committee by the Division of International Finance, Board of Governors of the Federal Reserve System, Washington, D. C.

The change in ownership, together with certain other changes in the 1948 legislation, clearly strengthened the government's control of the Bank; it has been said that under the 1948 legislation the Bank was "semi-nationalized." However, the government has always had strong influence over the Bank. Since its inception, the governor has been appointed by the Crown (for a 5-year term), and a government commissioner supervised operations to insure that they were conducted in the public interest. Article 29 of the pre-1948 statute, which remained unchanged in the 1948 law, provided that "the Minister of Finance has the right to control all operations of the Bank. He can oppose the execution of any measure which would be contrary to law, to the statutes [of the Bank], or to the interests of the State."

3. Relationship of the Central Bank to the Government

As is customary, the Bank acts as fiscal agent for the Treasury, as well as for certain other public and quasi-public agencies. It also makes funds available to the Treasury (against government or governmen-guaranteed paper) within a limit which for many years has been set at 10 billion francs ($200 million).

On the broader aspects of the government-central bank relationship, in Belgium that relationship has normally been one of harmonious and effective cooperation. The general view appears to be that the government has seldom abused its control over the Bank; and the latter has certainly spoken out or acted vigorously on many occasions, including several since 1948. One example was the Bank's unsuccessful fight in 1950 to have the "profit" on revaluation of the gold reserve used to reduce Treasury debt to the Bank rather than for new expenditure. Another example was the Bank's adroit handling of the situation which arose in October 1957 when the government overdrew its account; the Bank secured agreement on speedy repayment of the excess in the next few months—which was carried out—and also appears to have used the occasion to force through a reform of certain weaknesses in the capital market and in the banking system which were directly related to government finance. However, these examples do not prove that the government's veto power has never been abused, or that its mere existence has not inhibited independence of Bank action. The two examples cited above evidence mainly the fact that since 1945 the Bank has had strong personalities in the governor's chair.

4. Relation of the Central Bank to the Commercial Banks

The National Bank of Belgium is empowered to discount, buy and sell commercial paper, to discount, buy, sell, or make advances against short-term and medium term government or government-guaranteed paper, and to buy and sell long-term government securities quoted on the stock exchange. While the organic law of the Bank does not require that its activities along these lines be confined to dealings with credit institutions and government agencies, its operations are largely with such institutions and agencies. Discounts by credit institutions at the National Bank are subject to ceilings established by the Bank.

Under the banking reform law of 1935 the banks are required to submit periodic reports to the National Bank, but in general are not supervised by the National Bank but rather by the Banking Commission, established by the same reform law.

5. Power of the Central Bank Over the Instruments of Monetary Policy

Subject to the will of the government through its powers over the Bank, the latter has formal control of all the usual instruments of monetary policy except reserve requirements, although its freedom and effectiveness of action has in the past been inhibited in certain respects by institutional arrangements which will be briefly indicated below. Reserve requirements have existed in Belgium only since 1946, when they were established by the Banking Commission under the banking reform act of 1935. The requirements established were largely secondary reserve (or "liquidity") ratios: the cash ratios were originally set at 4 to 6 per cent, and the cash plus government-security ratios at 50 to 65 per cent, depending upon size of bank (the higher ratios applying to the larger banks). In 1949 the cash reserve ratios were unified at 4 per cent. The establishment of these ratios had the effect of immobilizing a large part of bank holdings of government paper thereby tending to force the banks "into the Bank" when in need of funds, thus strengthening the central bank's control of the monetary situation. However, the secondary-reserve system has been far from an unmixed blessing, having introduced a considerable element of rigidity into the whole banking structure; and the banking reforms of last year included the grant of authority to the Banking Commission to lower the highest ratios from 65 to 50 per cent.

The National Bank's main instruments of monetary policy have been discount-rate policy, rediscount ceilings, and moral suasion. Open-market operations have thus far not been a significant tool of policy, for several reasons, including the government's previously automatic access to a portion of new bank deposits through the secondary reserve system, and other factors which have interfered with the Bank's pursuit of an independent open-market policy. The banking reform of 1957 opens up the definite possibility that open-market operations by the National Bank will gradually become a significant weapon of monetary control in Belgium.

6. Channels or Sources Supplying Business Capital

As in most other European countries, "autofinancing" (which we call reinvestment or "ploughing back" of profits) is an important source of business capital in Belgium. Another very important source is (or has been) the banks; although close connections between banks and industrial enterprises are also found in other European countries, they were very highly developed in Belgium, this system tracing back to the early activities of the *Société Générale*, which was also, as mentioned above, the first bank of issue in Belgium. During the 1920's, and continuing in the early 1930's, there was a rapid concentration of Belgian banks, and, along with this, intensification of business and banking affiliation, with the result that bank portfolios became heavily loaded with industrial securities. By the mid-1930's there was a strong movement toward reform of the banking system, due in part to a tendency to blame the banking system for the depression, or at least for the losses resulting from it. The main purpose of the banking reform act of 1935 was to do away with "mixed banking," generally then defined as the holding of industrial securities by banking organizations. In substance, and with few and limited exceptions, the reform law of 1935 made it unlawful for any banking corporation to own stocks or bonds issued by other corporations. However, the separation of banking and industry achieved under the 1935 law appears to have been more apparent than real.

Belgium, like many other countries, has a number of specialized institutions for assisting in the provision of business capital. Important among these are: the Institute for Rediscount and Guaranty, which can discount banking assets not eligible for rediscount with the central bank (which, however, may rediscount bills guaranteed by the I. R. G.) ; the National Industrial Credit Company (S. N. C. I.), which assists in financing new industries, new products, and modernization programs, as well as credit margins in bilateral payments agreements, and which is also supposed to assist in financing the credits granted by the Belgian-Luxembourg Economic Union to the European Payments Union. (Note that Luxembourg has no central bank separate from that of Belgium.) During the past few years, however, the activities of the S. N. C. I. have been greatly curtailed by lack of funds. There is also a National Fund for Credit to Trade and Industry (to provide special credit for small and medium-sized enterprises), a fund to provide government guarantees for exports (i. e., guarantees of convertibility of foreign exchange proceeds), a fund for agriculture, and a fund for the provision of mortgage credit for low-cost housing.

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STRUCTURE OF THE BELGIAN CREDIT SYSTEM*

The present structure of the Belgian credit system has its origin in the banking law of 1935, which led to the drawing of a distinction between holding companies on the one hand and deposit banks on the other, the name "bank" being reserved solely for institutions operating mainly in the short-term sector.

The *National Bank of Belgium* is a private company, but one-half of its share capital is owned by the state. It can influence the monetary and credit situation by means of: (i) changes in the official discount rate; (ii) quantitative credit control (i. e., by fixing ceilings for the rediscounting facilities granted to the banks); (iii) qualitative credit control, which is applied especially in connection with the refinancing of foreign trade; (iv) recommendations to the banking system.

In Belgium there is a *Banking Commission* which is entrusted, under the banking law, with the control of the banks and of capital issues, and which is also authorised to fix ratios governing the composition of the banks' assets. There also exists a Banks' Association. There are altogether eighty-one *deposit banks*, but the three biggest ones account for at least two-thirds of the total resources of these institutions. Of the B.fcs 79 milliard of deposits held by Belgian banks at the end of 1955 70 per cent. were sight deposits.

The *Postal-Cheque Office*, which is directly dependent on the postal administration, is not a credit-granting institution, since its deposits immediately become Treasury resources (as is the case in most other countries). It pays no interest on deposits, which are used either by private individuals and enterprises or by the various government departments solely for the purpose of making payments. At the end of November 1956 there was an amount of nearly B.fcs 22 milliard outstanding on these postal-cheque accounts on private account alone. The "Caisse générale d'épargne et de retraite" is a non-profit-making public institution which combines the functions of a savings-bank with those of a social-insurance institution. At the end of 1955 the total resources of the "Caisse" amounted to B.fcs 86 milliard, i. e. B.fcs 4 milliard less than the combined resources of all the banks. Nearly 70 per cent. of the resources of the "Caisse" were in the form of savings deposits. The resources of the "Caisse" are invested for the most part in government or government-guaranteed securities and in mortgage loans.

Public and semi-public credit institutions. There are nine of these altogether and they include the "Société nationale de crédit à l'industrie" and the "Institut de réescompte et de garantie".

*Bank for International Settlements, Monetary and Economic Department, "Credit and Its Cost" (CB 268), Basle, Switzerland, January 1957.

The former is chiefly concerned with making medium-term loans to industry. Its resources are derived mainly from the issue of bonds and savings certificates. The second institution is a kind of "money market" in itself. Usually, but not always, it accepts from the deposit banks all their free funds at call or at short notice and it passes on such amounts as it does not itself require to other public institutions such as the "Fonds des rentes", etc. At the end of December 1956 the interest rates allowed on such funds were 1.70, 1.80, and 1.90 per cent. for one, five and ten days respectively. When in need of additional resources the "Institut de réescompte et de garantie" rediscounts bills of less than 120 days currency at the central bank. The lending activity of this institution is limited almost exclusively to buying foreign trade acceptances and to mobilising the banks' portfolios.

The other credit institutions chiefly grant credits of a special nature, often at long term, to agriculture, small industries, local authorities, the housing sector, etc.

The National Bank of Belgium applies a number of different official rates for discounts and advances. From 4th August 1955 to 5th December 1956 the most important rates were as follows:

(i) for the discounting of trade bills (up to 120 days): 3 per cent.

(ii) for advances against public securities at more than 12 months: 4.75 per cent.

Since 6th December 1956 these rates have been ½ per cent. higher; i. e., 3½ and 5¼ per cent. respectively. At the end of 1956 the returns of the Belgian National Bank showed rediscounts of trade bills at B.fcs 6.8 milliard and advances at only B.fcs 738 million—a state of affairs which is clearly related to the cost differential between the two kinds of refinancing.

The rates paid by the banks to depositors are fixed by interbank agreements. The big commercial banks pay ½ per cent. on sight deposits and up to 2¼ per cent. on time deposits at one year. Savings and mortgage institutions pay up to 3 per cent. on savings deposits and somewhat over 4½ per cent. on 5-year cash certificates.

There is no official general agreement regarding the rates (interest and commission) to be charged to borrowers. On an average the big banks add between 1 and 2 per cent. to the official Bank rate applied to discounts of 120-day trade bills and to secured advances, so that the cost of short-term borrowing is 4½ to 5½ per cent. for the former type of credit and 6¼ to 7¼ per cent. for the latter. Up to 7½ per cent. is charged on overdrafts.

Medium-term credit is granted for the most part by public and semi-public institutions, which charge an average rate of 5¾ per cent. When granted by the big commercial banks (out of funds raised by the issue of cash certificates) medium-term credit costs 7¼ to 8 per cent. Mortgage loans granted by mortgage banks cost 5¾ to 6¾ per cent.

A very large number of "special credits" for particular purposes are granted, in limited amounts, by the public or semi-public institutions at rates which are often much lower than the normal ones quoted above for medium and long-term credits.

In the capital market the yield of long-term state loans at the end of 1956 was 5½ per cent. and that of corporate bonds 5 to 5¼ per cent. The real cost to industrial corporations of raising long-term funds on the capital market is, however, considerably higher than the yield of corporate bonds and this explains—at least in part—the very small volume of new private issues.

A summary of the present structure of Belgian interest rates is given below.

Belgium: Main rates paid and charged by credit institutions [1] *(including commission, etc.)*

[In percentages]

Items	Central bank	Commercial banks	Other credit institutions
Rate paid on deposits—			
Sight		½	
Time and savings		Up to 2½	Up to 3.
Cash certificates		3½ to 4	3½ to 4½.
Rate charged on—			
Trade bills (discounting)	3½	4½ to 5½	
Advances	5¼	6¼ to 7¼	5¾.
Overdrafts		Up to 7½	
Medium-term loans		7¼ to 8	5¾.
Mortgage loans			5¾ to 6¾.

[1] Since Dec. 6, 1956.

BELGIAN SYSTEM OF TAXATION*

The first part of this section is devoted to direct taxation (see chapters A and B); the second deals with indirect taxation (see chapter C).

With regard to direct taxation, the Belgian system differs from the American system. In Belgium a distinction is made between three categories of income, which are taxed according to their nature. There are three major scheduled taxes :

1. *the real property income tax or real estate tax* (« contribution foncière ») levied on income from property such as land and buildings.

2. *the personal property income tax* (« taxe mobilière ») levied on income from personal property assets such as investments, loans, deposits, etc.

3. the *professional tax* (« taxe professionnelle ») levied on salaries, wages or other compensation, and on undistributed corporate profits.

In addition to these three major taxes, a so-called *national crisis tax* (« contribution nationale de crise ») is levied on income taxable under the real property income tax, and on certain categories of income taxable under the personal property income tax. This tax was instituted in 1933 as a temporary measure and has been maintained since.

On the other hand, a *personal complementary tax* (« impôt complémentaire personnel ») is levied on the total income of individuals only, who are residents of Belgium.

Local governments (provinces and municipalities) are also authorized to levy taxes, restricted to two categories :

1. an additional tax to the real property income tax (« additionnels ») which is collected at the same time as the latter by the Internal Revenue authorities (« Administration des Contributions Directes »).

2. certain other taxes of limited importance.

The Belgian system of direct taxation, in its application to the activities of corporations and to the income of management and personnel, is described in the following pages.

A. CORPORATE TAXATION

1. Real Property Taxation.

Income from land and buildings located in Belgium is subject to two taxes : the *real property tax* and the *national crisis tax*. However, local governments are authorized to levy an additional tax on this income.

These taxes are assessed on the estimated income, called «cadastral» income, determined in advance on a yearly basis for each piece of real property by the Land Register (« Administration du Cadastre »). As a

*Office Belge du Commerce Exterieur, Bruxelles, July 1956.

rule, this amount remains unchanged for a 20-year period. The « cadastral » income is well below the real income — frequently it does not exceed one-fifth of the actual income — since it is computed on the basis of economic criteria dating from a period prior to 1940.

Rate of these taxes :

The real property tax is computed at a 6 % rate, the national crisis tax on a graduated scale which ranges from 2 to 15 %. The additional tax levied by local authorities varies according to provinces and municipalities. Its average is about 30 %.

REAL PROPERTY INCOME TAX

Net taxable income In Belgian francs		In Dollars		% including the national crisis tax	Additional tax (Local Gov't.) Average %	Total
From	To	From	To			
0	2,999	0	59	8	30	38
3,000	9,999	60	199	9	30	39
10,000	24,999	200	499	10	30	40
25,000	49,999	500	999	12	30	42
50,000	99,999	1,000	1,999	14	30	44
100,000	149,999	2,000	2,999	16	30	46
150,000	199,999	3,000	3,999	18.5	30	48.5
200,000 and over		4,000 and over		21	30	51

2. Taxation of Corporate Profits.

A distinction is made in Belgium between undistributed profits and distributed profits with respect to taxation. Undistributed profits are liable to the *professional income tax,* whereas distributed profits are subject to the *national crisis tax* and to the *personal property income tax.* When profits, held in a reserve, are distributed later, the amount of the professional income tax previously paid is deducted from the combined national crisis tax and personal property income tax which become due upon distribution.

a. Undistributed Profits.

A *professional income tax* is payable on the undistributed profits (income kept in reserve and non-deductible expenses).

Deductible items from the gross income include : rent, interest on loans, wages and salaries, certain losses, normal amortization on the depreciation of equipment and property, maintenance costs and certain taxes, namely the professional income tax paid on the profits of preceding calendar or fiscal years, or accrued during the taxable period, and the real property tax; the national crisis tax is not deductible. With regard to losses, the taxpayer is authorized to deduct from the profits of the year losses incurred in the course of the preceding five years (this provision aims at taking business cycles into account).

Rate of the professional income tax :

(i) In the case of a Belgian corporation, or of a corporation established under Belgian law, such as a subsidiary of a foreign corporation:

On that part of the net taxable amount in: Belgian francs	Dollars	Rate
From 0 to 150,000	From 0 to 3,000	25 %
From 150,000 to 500,000	From 3,000 to 10,000	30 %
From 500,000 to 1,000,000	From 10,000 to 20,000	35 %
From 1,000,000 to 10,000,000	From 20,000 to 200,000	37.5 %
From 10,000,000 and over	From 200,000 and over	40 %

(ii) In the case of a joint-stock corporation (i.e. Société par actions) not established under Belgian law, such as a branch of a foreign corporation, a flat rate of 40 % is applied on the entire profit.

Method of payment.

The professional income tax should be paid in advance. Failure to do so requires the payment of an additional amount set at a percentage of the professional income tax, i.e. 10 % on that part of the professional income tax which is paid after the 15th day following the end of the first half of the calendar year or fiscal year, but before the 15th day following the end of that year, and 20 % on the remainder.

Notes.

(i) *Deductibility of the professional income tax.*

The professional income tax paid during a fiscal year or calendar year on income « of » previous years can be deducted from the profits of that same period. For instance, a professional income tax paid in 1954 on 1952 or 1953 incomes is deductible from 1954 profits. Consequently, the possibility of such deduction decreases the rate of the tax computed in direct ratio to the business profits (i.e. the profits before taxes).

A case in point would be the situation of a Belgian establishment of an American corporation. If, for instance, similar profits, taxed at a 40 % rate, were made in the course of several years, the following would be the actual payments, the hypothetical profit before taxes being 100 :

Profits of	Taxable base	Tax	Percentage in relation to profits
1st year : 100	100	40	40
2nd year : 100	60	24	24
Other years : 100	Average about 70	Average about 30	About 30

(ii) *Amortization.*

Amortization is based on the investment value of amortizable assets and is limited to that value. In order to facilitate the re-equipment of enterprises, a law effective as of August 20, 1947, permits amortization on a re-evaluated basis. The taxpayer can amortize all equipment, as well as industrial or other similar buildings which existed prior to the war, and which are still in use, by application of a new, re-evaluated rate, which makes allowance for the decrease in purchasing power of Belgian currency.

For practical purposes, the Belgian tax administration has adopted a system of annual overall percentages, by category of asset, arrived at in mutual agreement with the taxpayer. These percentages are computed liberally with a high safety margin, designed to cover all unforeseen circumstances (accidental destruction and deterioration, renovation because of obsolescence with a view towards increasing production or reducing costs, etc.).

b. **Distributed Profits.**

(i) A *national crisis tax* of 20 % is applicable to gross dividends. It is always borne by the company and paid by it from undistributed profits within 15 days of the distribution of dividends.

(ii) A *personal property income tax* of 30 % is applicable to gross dividends. This tax may be withheld by the corporation prior to distribution of dividends to shareholders but it is paid by the corporation. The dividend received by shareholders is exempt from further taxation with the exception of the complementary personal tax which is payable only by individuals, residents of Belgium, on their overall income.

Note concerning these two taxes on dividends.

The combined rate of the national crisis tax and the personnal property income tax on dividends, expressed in proportion to profits before taxes, is not 50 % (20 % + 30 %), but is at most about 45 %. Indeed, if a corporation decides to issue a hypothetical gross dividend of 100, it will have to pay a 30 % personal property income tax, and thus the net dividend paid out to the stockholder will be 70. In addition, the gross dividend of 100 is subject to a 20 % national crisis tax which is paid out of undistributed profits. Since undistributed profits are subject to the professional income tax, that portion of the profits which is destined for payment of the national crisis tax — which is not a deductible tax — will also carry a maximum fiscal charge of $20 \times 40/100 = 8$ (if the professional income tax is computed at a maximum rate of 40 %).

Therefore, the total amount of taxes affecting a gross dividend of 100 can be summarized as follows :

Personal property tax on dividend	30
National crisis tax	20
Professional tax on national crisis tax	8
	58

As a consequence, a corresponding amount in profits of 128 will be needed by a corporation to distribute 70 in net dividend. *As a result total incidence of the combined taxes on distributed profits, expressed in proportion to profits before taxes, is :*

$$\frac{30 + 20 + 8}{128} = 45.3\ \%\ \text{maximum}$$

Examples of the Computation of Corporate Taxes.

(Note : For the computation of taxes, franchises have not been taken into account, resulting from the law of July 1, 1954, which brings into effect fiscal amendments, destined to favor productive investments. This is due to the fact that afore-mentioned law has been approved for a limited lenght of time, and is only applicable to productive investments operated between July 1, 1954 and June 30, 1956).

An American establishment has been created in Belgium at the end of 1953. The value of fixed assets (land, buildings, and certain equipment) amounts to B.Fr. 4,500,000; the cadastral income is B.Fr. 50,000.

In 1954 and 1955 profits of respectively B.Fr. 1,000,000 and B.Fr. 2,000,000 are put in reserve. In 1956 B.Fr. 1,000,000 are put in reserve and B.Fr. 2,000,000 are used for distribution of dividends.

Every year the corporation pays the professional income tax on reserved profits as follows : 60 % during the first semester; 30 % during the second; and the remaining 10 % later.

Case of :

A. — **A corporation established under Belgian law.**

	1954	1955	1956
(1) **Profits :**			
(a) **non-distributed**	1,000,000	2,000,000	1,000,000
To be added :			
national crisis tax, included in overhead (non-deductible tax)	4,000	4,000	4,000
	1,004,000	2,004,000	1,004,000
To be deducted :			
cadastral income	50,000	50,000	50,000
profits subject to professional income tax	954,000	1,954,000	954,000
(b) **distributed :**			
profits subject to personal property income tax and national crisis tax payable on dividends	—	—	2,000,000
(2) **Taxes payable :**			
(a) on real property :			
(real property income tax : 18,000 and national crisis tax : 4,000)	22,000	22,000	22,000
(b) on non-distributed profits : (professional income tax)	316,470	709,012	316,470
(c) on distributed profits :			
(personal property income tax)	—	—	600,000
(national crisis tax)	—	—	400,000
Total	338,470	731,012	1,338,470

(3) **Fiscal Burden :**

In order to determine the fiscal burden, one has to take into account that taxation only applies to profits after computation of professional income tax and real property income tax. Computed in relation to the operating profit, prior to deduction of any taxes, this burden is broken down as follows :

Profits resulting from the books (i.e. balance of the profits and losses account)	1,000,000	2,000,000	3,000,000
Taxes included in overhead expenditure:			
— Real property income tax and national crisis tax	22,000	22,000	22,000
— Professional income tax	—	316,470	709,012
Operating profit (before taxes)	1,022,000	2,338,470	3,731,012
Taxes payable	338,470	731,012	1,338,470
Ratio	33.1 %	31.2 %	35.8 %

B. — **A corporation not established under Belgian law.**

	1954	1955	1956
(1) **Profits :**			
Balance of profits and losses account	1,000,000	2,000,000	3,000,000
To be added :			
National crisis tax (see above)	4,000	4,000	4,000
	1,004,0000	2,004,000	3,004,000
To be deducted :			
Cadastral income	50,000	50,000	50,000
Amount subject to professional income tax	954,000	1,954,000	2,954,000
(2) **Taxes payable :**			
— Real property income tax (18,000) and national crisis tax (4,000)	22,000	22,000	22,000
— Professional income tax	400,680	820,680	1,240,680
Total	422,680	842,680	1,262,680
(3) **Fiscal burden :**			
Profits resulting from the books (balance of profits and losses account)	1,000,000	2,000,000	3,000,000
Taxes included in overhead expenditure:			
— Real property income tax and national crisis tax	22,000	22,000	22,000
— Professional income tax	—	400,680	820,000
Operating Profit (before taxes)	1,022,000	2,422,680	3,842,680
Taxes payable	422,680	842,680	1,262,680
Ratio	41.3 %	34.7 %	32.8 %

Computation of various taxes, as applied to afore-mentioned case-matters.

1. **Real property tax and national crisis tax** (see pages 7 and 8).

— real property tax	50,000 × 0.36 =	18,000
— national crisis tax	50,000 × 0.08 =	4,000
Total		22,000

2. **Professional tax on reserved profits** (as computed for 1955 in the case of a corporation established under Belgian law).

Reserved Profit	2,000,000
— to be added : national crisis tax	4,000
— to be deducted : cadastral income of the professionnally used real property	50,000
taxable amount	1,954,000

Professional income tax :

on	150,000 : 25.– % =	37,500
on	350,000 : 30.– % =	105,000
on	500,000 : 35.– % =	175,000
on	954,000 : 37.5 % =	357,750
	1,954,000	675,250

Increases :

on 60 %	
on 30 % (202,575 × 10 %)	20,257
on 10 % (67,525 × 20 %)	13,505
Total	709,012

3. **Personal property tax on dividends and national crisis tax** (as computed for 1956 in the case of a corporation established under Belgian law).

Amount of payable gross dividends (only the personal property income tax is withheld on the taxable income) = ...	2,000,000
Personal property income tax : 2,000,000 × 30 % = ...	600,000
National crisis tax : 2,000,000 × 20 % = ...	400,000

Practically, as stated on page 10, total rate of taxes payable on dividends is 45.3 % at most, instead of 50 %.

4. **Professional tax on the total profits of a corporation not established under Belgian law** (as computed for 1956).

Balance of the profits and losses account	3,000,000
To be added : national crisis tax	4,000
To be deducted : cadastral income of the professionally used real property	50,000
	2,954,000

Professional income tax : 2,954,000 × 40 % = 1,181,600

Increases :

on 60 %		
on 30 % (354,480 × 10 %)	35,448	
on 10 % (118,160 × 20 %)	23,632	
Total . . .		59,080
		1,240,680

B. INDIVIDUAL INCOME TAXES

1. « Professional » (1) Income Tax (« Taxe Professionnelle »).

This tax is levied on the annual net professional income of the individual, i.e. his gross « professional » income less expenses. For wages and salaries, these expenses are set at one fourth of the gross income; the amount of that deduction, however, may not exceed total deductible taxes by more than B.Fr. 60,000 ($ 1,200). Should the professional expenses be higher than one-fourth of the gross income, the taxpayer is entitled to submit appropriate evidence and to claim the total amount of his professional expenses as a deduction. In the case of company directors, the following can be deducted from their gross income : either a figure set at 5 % of their gross income to which is added the amount of deductible taxes, or the actual amount of professional expenses.

(1) In this chapter, the term « professional » refers to all positions from which a salary, wage, or other compensation is derived and also includes pensions and business profits.

Rate :

In Belgian Francs

On net income : From	To	Tax
0	149,999	50 to 27,500
150,000	249,999	27,500 + 27.5 % on the amount in excess of 150,000
250,000	499,999	55,000 + 30.– % on the amount in excess of 250,000
500,000	999,999	130,000 + 32.5 % on the amount in excess of 500,000
1,000,000 and above		292,500 + 35.– % on the amount in excess of 1,000,000

In Dollars

On net income : From	To	Tax
0	2,999	1 to 550
3,000	4,999	550 + 27.5 % on the amount in excess of 3,000
5,000	9,999	1,100 + 30.– % on the amount in excess of 5,000
10,000	19,999	2,600 + 32.5 % on the amount in excess of 10,000
20,000 and over		5,850 + 35.– % on the amount in excess of 20,000

Example :

An individual with no dependent, whose annual taxable income is Belgian francs 2,000,000 ($ 40,000), would be subject to a professional tax computed as follows :

On that part of his income (as expressed in Belgian francs)

From B.Fr. 0 to 1,000,000	B.Fr. 292,500
From B.Fr. 1,000,000 to 2,000,000 (1,000,000 × 0,35) . .	B.Fr. 350,000
	B.Fr. 642,000

On that part of his income (as expressed in dollars)

From $ 0 to 20,000	$ 5,850
From $ 20,000 to 40,000 (20,000 × 0,35)	$ 7,000
	$ 12,850

Method of payment :

The professional tax on salaries and wages is withheld at the source by the employer. The professional tax on directors' compensation must be paid in advance, as in the case of professional tax on reserved corporate profits (see page 9).

2. Personal Property Income Tax (« Taxe Mobilière »).

This tax is levied on personal income from such sources as investments, loans or deposits. Only net income received is subject to taxation, and all expenditures related thereto are deductible. This tax also applies to income from real property located in a foreign country and owned by residents of Belgium, this income being exempt from the Belgian real property tax.

Rates :

These vary from 2 % to 30 % according to the nature of income. Income from personal and real property which has its source in other countries is taxed at a maximum 12 % rate which is generally much lower than the rates applicable to income from Belgian sources.

Method of payment :

This tax is generally withheld at the source by the person or company paying the income on which the tax is collected.

3. Real Property Income Tax (« Contribution Foncière »).

Personal income from land and buildings is subject to a real property tax as previously described on pages 7 and 8.

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4. Personal Complementary Tax.

This tax is levied on the overall net income previously taxed under the real property tax, the personal property tax or the professional tax. It is applicable only to individuals which are residents of Belgium.

The incidence of the personal complementary tax is, however, reduced by various possible deductions, such as :

— 15 % of the income subject to the professional tax but this deduction may not exceed Belgian francs 30,000 ($ 600).

— certain taxes — if they have not been deducted in the computation of scheduled taxes — such as the real property income tax, the personal property income tax, and the personal complementary tax.

— deductions for dependents (the rates are the same as those used for the computation of the professional income tax, see page 16).

Rate :

In Belgian Francs

On that part of net income From (1)	To (2)	Tax on the amount shown in column (1)	% of amount shown in column (1)	Rate applicable to difference between amounts shown in columns (1) and (2) %
0	50,000	—	0.50	—
50,000	100,000	250	0.50	3
100,000	150,000	1,750	1.75	5
150,000	200,000	4,250	2.83	10
200,000	250,000	9,250	4.62	14
250,000	300,000	16,250	6.50	20
300,000	600,000	26,250	8.75	24
600,000	800,000	98,250	16.37	26
800,000	1,000,000	150,250	18.78	28
1,000,000	and above	206,250	20.62	30

In Dollars

0	1,000	—	0.50	—
1,000	2,000	5	0.50	3
2,000	3,000	35	1.75	5
3,000	4,000	85	2.83	10
4,000	5,000	185	4.62	14
5,000	6,000	325	6.50	20
6,000	12,000	525	8.75	24
12,000	16,000	1,965	16.37	26
16,000	20,000	3,005	18.78	28
20,000	and over	4,125	20.62	30

Example :

A director has a gross income of B.Fr. 600,000 ($ 12,000), composed of a salary and other compensation amounting to B.Fr. 400,000 ($ 8,000) and net dividends of B.Fr. 200,000 ($ 4,000). In his case, the deductions, the taxable base, and the tax, would be computed as follows :

Gross Income		B.Fr. 600,000	$ 12,000
Less « professional » expenses (estimate)		80,000	1,600
Net Income		B.Fr. 520,000	$ 10,400
Deductions :			
- 15 % of the net income from salary and other compensations :			
(B.Fr. 320,000 × 0,15 = B.Fr. 48,000)			
Maximum deductible	B.Fr. 30,000		
- Deductible taxes	B.Fr. 60,000	B.Fr. 90,000	$ 1,800
Actual taxable base		B.Fr. 430,000	$ 8,600
Personal Complementary tax :			
On that part from B.Fr. 1 to 300,000		B.Fr. 26,250	$ 525
On that part from B.Fr. 300,000 to 430,000		31,200	624
		B.Fr. 57,450	$ 1,149

Deductions for Dependents :

The following can be deducted from the professional income tax and personal complementary tax :

5 % for one dependent	30 % for four dependents
10 % for two dependents	50 % for five dependents
20 % for three dependents	70 % for six dependents

These deductions, however, apply only to taxes payable on the first B.Fr. 250,000 ($ 5,000).

Example :

An employee has an annual income of B.Fr. 200,000 ($ 4,000) and he claims two dependents (wife and child) :

	B.Fr.	$
a) **Professional tax :**		
Annual salary	200,000	4,000
Deduction for professional expenses (25 %)	50,000	1,000
Taxable base	150,000	3,000
Basic professional tax (1)	27,500	550
Deduction for 2 dependents (10 %)	2,750	55
Net professional tax	24,750	495
b) **Personal Complementary Tax :**	B.Fr.	$
Income taxable under the professional tax	150,000	3,000
Various other deductions, estimated at	25,000	500
Taxable base	125,000	2,500
Basic personal complementary tax (1)	3,000	60
Deduction for two dependents (10 %)	300	6
Net personal complementary tax	2,700	54

(1) For rates, see page 14.

Convention between the United States and Belgium concerning Taxes on Income (1).

A convention between the United States and Belgium in force since January 1, 1953, prevents the double taxation of income. In accordance with this convention :

1. the United States allows as a deduction from the income taxes imposed by the United States the appropriate amount of taxes paid to Belgium, whether paid directly by the taxpayer or by withholding (article XII (2)—);
2. citizens or residents of the United States who are also residents of Belgium are liable to the same taxes as Belgian residents; however the personal complementary tax on income from sources within and taxed in the United States, is reduced to ¼ in their case (article XII (3)(c)—);
3. citizens or residents of the United States who are not residents of Belgium and have no permanent establishment in Belgium are liable to scheduled taxes only on that part of their income which has its origin in Belgium; they are not subject to the personal complementary tax (article VIII (2)—).

C. INDIRECT TAXES.

These taxes can be divided into two categories :

a. Taxes on business operations, which include recording fees, stamp taxes, and the transfer tax.

b. Consumer taxes, which include custom duties and excise duties.

a. Taxes on business operations :

1) **Recording and Stamp Fees** (Droits d'enregistrement et de timbre).

For the larger part these fees are collectible on documents certified by public officials (notaries, etc.).

Among the agreements in current use the following are subject to payment of recording fees :

— sales of real estate located in Belgium (11 %);
— leases of real estate located in Belgium (0.2 %);
— mortgage debentures (1 % + a 0.2 % mortgage fee);
— founding of a Belgian company or new stock issues (1.5 % on the gross value of acquired assets, except subject to a 3.5 % fee).

These rates are reduced to 0.5 % and 1.2 % respectively :

1° in the case of the reorganization of a company in a new one of a different kind, provided the existence of the new company does not exceed that of the old one;

2° for a merger, provided :

a) that, in case of merger by founding of a new company, the business life of the latter does not exceed that of the merging companies;

b) that, in case of merger by absorption, the business life of the absorbing company does not exceed by more than two years at most that of the absorbed companies.

(1) The present brochure does not purport to examine the various provisions of this Convention.

This condition regarding the companies' existence was abolished by a law of July 20, 1955, in the case of merger operated at last on December 31, 1957, between companies founded prior to January 1, 1955, provided the Ministry of Economic Affairs certifies that the merger tends to increase productivity, to decrease unemployment or to rationalize the economy.

On the other hand, the Government has adopted a bill tending to reduce the same rates to 0.5 % and 1.2 % for contributions made to companies by others and which consist of one or several of their production lines. Here also mergers should occur prior to December 31, 1957, and the same conditions are applicable as the one provided for by the law of July 20, 1955.

— Extension of a company's existence (1.5 % on the company's net worth).

Particular acts of foreign companies are subject to collection of the following recording fees.

1. Without any branch or site of operations of any kind in Belgium :
   (a) Organization of a company or an increase in its capital : as a rule, 6,000 Belgian Francs. If the contribution represents real estate located in Belgium : 3.5 % on this contribution only, with a minimum of 6,000 Belgian Francs per document or deed;
   (b) Extension of business life : 6,000 Belgian Francs.

2. With branch or site of operations of any kind in Belgium :
   (a) Organization of a company or an increase in its capital, 0,1 %; inasmuch as the contribution consists of real estate located in Belgium, 3.5 %;
   (b) Extension of business life : 0.1 %.

The minimum fee per document (except for increases in capital when the act of establishment or extension was recorded in Belgium) is 12,000 Belgian Francs.

The 0.1 % fee is collected on the company's capital in the case of organization or extension, and on the amount of the increase in the case of an increase in capital.

These fees are usually collectible when these companies publish their statutes according to Art. 198 and 199 of the integrated laws governing commercial companies, i.e., in case of establishment of any branch or site of operations in Belgium, or in case of public issuance, posting, offer and sale of stock, or even in the case of their official listing on a stock exchange.

In order to avoid paying these fees, the foreign company, instead of establishing a branch, can always establish in Belgium a subsidiary with small capital legally independent from the parent company, except for general corporate regulations.

The stocks and bonds of Belgian stock companies are subject to a stamp tax of 0.7 % (for bonds maturing within five years, 0.35 %). This fee is calculated on a lump sum basis : for stock, on the amount of statutory capital of the company and, for debt certificates, on the amount of the publicly floated loan.

With regard to stock certificates of foreign companies, organizations or authorities, the stamp tax is fixed at 1.6 % of their value. This stamp tax is due either at the time of delivery of the certificate by a broker or banker established in Belgium, upon borrowing money or concluding a transaction in Belgium, or when turned over as security to a broker or a banker.

Finally, certificates issued by individuals or legal entities established in Belgium and provided they represent foreign public funds, are likewise subject to a stamp tax of 1.6 %. This fee is due upon signature of the said certificates.

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2) Transfer Tax («Taxe de Transmission») and Related Taxes («Taxes assimilées au timbre»).

A transfer tax is collected on merchandise transactions (sales, loans, transportation, etc.) when effected in Belgium, on importation of goods and on contracts for services (advertising contract, etc.).

Rate : 5 % as a rule
11 or 13 % in the case of luxury items.

A number of goods, however, are taxed only once at a 10 % rate to avoid the pyramiding effect of the transfer tax on the occasion of each transaction. Such a tax is applied either at the time of sale from the factory or at the time of importation of goods, or when they are sold to the consumer or to an industrial enterprise, or, quite exceptionally, when they are exported.

In addition to the transfer tax, a related invoice tax (« Taxe de Facture ») of 0.5 % is applicable to various business transactions.

— *Transfer Tax on Imports.*

As a rule, a transfer tax is levied on imports at the same rate as the one used in the case of internal transactions. A slightly higher rate is applicable to a few imports to offset the disadvantage resulting from a heavier indirect taxation on some domestic goods.

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b. Consumer Taxes.

1) Custom Duties.

Custom duties are generally imposed ad valorem. Rates are very low. They are determined by the customs convention between Belgium, the Netherlands, and Luxembourg (Benelux). As a consequence of this convention, goods move freely inside the combined territory of those three countries. Raw materials, unfinished products, and basic items, are imported tax free, or are lightly taxed (from 1 to 4 %). The highest rates used are approximately 24 %.

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2) Excise Duties.

They are levied on some products such as sugar, tobacco, alcohol, beer, mineral water, and light mineral oils, at the time of their manu-

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facture. When imported, such products are subject to an equivalent excise duty in addition to the custom duties and the transfer tax.

Export of Domestic Goods and Export of Goods Imported for Re-export.

No duty on exports exists in Belgium. Sales are exempt from the transfer tax when the goods are exported by the seller. Purchases made by the exporter are also exempt from the transfer tax, with the authorization of the Ministry of Finance. However, the 0.5 % invoice tax is chargeable. In addition, some goods may, under certain conditions, be imported provisionally free of duties and of a transfer tax. This applies to goods in transit, and to goods which are to be re-exported after remaining in a warehouse, or after undergoing industrial processing.

FRANCE

CENTRAL BANKING IN FRANCE*

1. Historical Setting

The Bank of France was organized by Napoleon in 1800 as a privately owned company engaged in general banking business. In 1803 it was given a monopoly of note issue in the Paris area, and in 1848 that monopoly was extended to all of France. In 1806 a General Council consisting of a governor and two vice-governors appointed by the chief of state, and 15 regents and 3 examiners elected by the 200 largest stockholders, was established as the chief governing agency of the Bank. This formal organizational structure of the Bank of France did not change for the next 130 years, but in the course of time actual power swung from the government at the time of Napoleon to private interests as represented by the regents in the early 1930's. In 1936, following the victory at the polls of the "Popular Front," which had made the power of the "200 families" a major political issue, legislation was passed which gave the government the dominant position in the management of the Bank, mainly by reducing the number of members of the General Council elected by the stockholders from 18 out of 21 to 2 out of 20. Effective January 1, 1946, the Bank of France was nationalized, the shareholders receiving negotiable government securities in exchange for their stock.

2. Ownership and Control of the Central Banking Institution

The General Council of the Bank of France consists of the Governor, the two Vice-Governors, four *ex officio* members who head the principal government financial institutions, seven members appointed by the Minister of Finance to represent various economic interests, one representative of the Bank's staff, and two examiners without vote on policy matters. The eight members representing economic interests and the Bank's staff are appointed for four-year terms, which are staggered. The Governor and Vice-Governors are appointed by government decree, and have indefinite tenure.

The capital stock of the Bank is owned entirely by the state. The profits of the Bank are committed for a long and indefinite period to amortize advances made by the Bank to the Treasury in 1957.

3. Relationship of the Central Bank to the Government

Because the Bank of France is nationalized and because its Governor does not have tenure for a specified period, the government has

*Prepared at the request of the Joint Economic Committee by the Division of International Finance, Board of Governors of the Federal Reserve System, Washington, D. C.

strong ultimate power over monetary policy. In practice the government in office influences monetary policy through the National Credit Council, which is the primary authority for framing credit policy and banking controls. The National Credit Council was established in December 1945 by the same law that nationalized the Bank of France. The Council has 43 members, including its president, who is a Minister designated by the government, and its vice-president, the Governor of the Bank of France. Seventeen members of the Council represent government departments concerned with economic problems, or are heads of public or semi-public financial institutions. The remaining 24 members represent various economic and financial interests, and are appointed by the Minister of Finance or the Minister of National Economy on the basis of nominations by organizations representing those interests, such as chambers of commerce and labor federations. The policies of the government in office are presented to the National Credit Council by the Director of the Treasury, who, though not a voting member, is required by law to attend all meetings of the National Credit Council and its committees. The President of the Council, who is usually the Minister of Finance, rarely attends its meetings, and the presiding officer is normally the Governor of the Bank of France.

The National Credit Council has extensive power to regulate the operations of all classes of banks, this power being exercised through the agency of the Bank of France. In matters of monetary and credit policy the Council formally has power only to advise the government and the Bank of France. In practice, however, it appears that the broad lines of monetray policy are laid down in the National Credit Council, although it is important to bear in mind that the Governor of the Bank of France has a key position in that body.

4. Relation of the Central Bank to the Commercial Banks

The Bank of France is empowered to discount commercial paper and government securities for private individuals and enterprises, all classes of banks, and public and semi-public financial institutions provided that maturities do not exceed three months and the commercial paper bears three signatures. By far the greater part of the Bank's business is with the commercial banks and public and semi-public financial institutions.

5. Power of the Central Bank Over the Instruments of Monetary Policy

Within the policy framework established in the National Credit Council, the General Council of the Bank of France makes the important decisions of the Bank, including changes in discount rates. There are no cash reserve requirements, but since 1948 the commercial banks have been required to hold about 25 per cent of their deposits in the form of short-term government securities. The Bank of France has been empowered since 1938 to conduct open-market operations, but until June 1957 it was inhibited from making effective use of open-market operations as an instrument of monetary policy by—among other things—a law requiring the Bank to discount all

Treasury securities of up to 90 days' maturity presented to it. Open-market operations have been used mainly to smooth out day-to-day fluctuations in the money market.

6. Channels or Sources Supplying Business Capital

In the postwar period the Bank of France has become an important source of medium-term financing of industry, agriculture and construction. Most of the private obligations discounted by the Bank of France for public and semi-public institutions is medium-term credit, which technically takes the form of 90-day paper, but which actually runs for periods up to five years. Among the most important public and semi-public institutions engaged in medium- and long-term financing are the following: The Caisse des Dépots et Consignations, a publicly-owned institution which manages the funds of the social security and postal savings system, and other government funds; the Crédit Foncier de France, which grants loans on property; its subsidiary, the Sous-Comptoir des Entrepreneurs, which specializes in financing the building industry; the Caisse Nationale de Crédit Agricole, which rediscounts obligations of regional agricultural cooperative societies; and the Crédit National, which was founded in 1919 as an independent governmental agency to aid in the reconstruction of war-damaged enterprises, but which has over the years been given a variety of functions connected with government and industry financing.

In France, the commercial credit needs of small- and medium-sized business are served by the Popular Banks, which have discount privileges at the Bank of France. The Casse Centrale de Crédit Hôtelier Commercial et Industriel, a semi-public institution under the control of the Popular Banks, grants long- and medium-term loans to small- and medium-sized business.

STRUCTURE OF THE FRENCH CREDIT SYSTEM*

The *Bank of France* applies all sorts of measures of credit control: changes in the discount rate, the imposition of rediscount ceilings, the control of minimum reserves to be held by the banks in the form of Treasury paper, open-market operations and certain measures of qualitative control. The administrative supervision of the banking system is carried out by the "Commission de Contrôle des Banques", while the "Conseil National du Crédit" regulates the practice of the banking profession and takes part in the shaping of credit policies.

The French banking system was placed on a legally organised basis by the laws of 1941 and 1945. The banks are divided into three main groups:

(i) *Commercial banks* (banques de dépôts);

(ii) *Long and medium-term credit banks*, which receive deposits at more than two years; and

(iii) *Investment banks* (banques d'affaires), whose main activity is the taking-up and administration of participations and the granting of credits for unlimited periods to enterprises in which the participations are held. These investment banks can invest in these enterprises only their own funds or deposits entrusted to them at fixed term or at notice for at least two years. They can also receive sight deposits and deposits at less than two years, but only from certain categories of persons and from the enterprises with which they are connected.

The *commercial banks* (some 340 in number) account for more than 85 per cent. of the assets of all registered banks, and of that 85 per cent. the four big nationalised banks account for almost one-half. The commercial banks receive almost exclusively sight deposits. Actually they are practically the only type of institution authorised to accept sight deposits and deposits at less than two years. In practice the commercial banks lend only at short term (mostly by the discounting of trade bills). Theoretically they could also grant medium-term credit; in fact, however, they usually mobilise medium-term paper only when the central bank has previously agreed to rediscount it.

In addition to the private institutions (including those which have been nationalised) there are in France a number of semi-public and public financial institutions, the most important of which are:

The "*Crédit Foncier*", established to grant long-term loans on mortgage to property owners, local authorities and the merchant marine. It obtains the greater part of its resources by the issue of various types of bonds. Since 1950 the "Crédit Foncier" has also played an increasingly important part in the granting of long and medium-term credit for house-building.

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*Bank for International Settlements, Monetary and Economic Department, "Credit and Its Cost," (CB 268), Basle, Switzerland, January 1957.

The "*Caisse Nationale de Crédit Agricole*" is the central organisation of the various local and regional agricultural credit societies. These institutions receive funds from private depositors, from the Treasury, and also through the issue of bonds on the capital market. These funds are normally used to refinance the long, medium and short-term credits granted by the affiliated local societies. The "Caisse Nationale de Crédit Agricole" is also allowed rediscounting facilities at the central bank.

The "*Crédit Populaire*" consists of a number of small co-operative banks designed to aid small businesses and industry and its central organisation is the "Caisse Centrale de Crédit Populaire". The "*banques populaires*" are governed by a special legal statute which gives them a semi-public character. They receive deposits from the public and also advances from the "Fonds de développement économique et social" and are allowed rediscounting facilities at the central bank.

The "*caisses d'épargne*" and the "*Caisse Nationale d 'Epargne*" are the recipients of the greater part of French savings in monetary form. The former are municipal institutions, while the latter is a government agency attached to the Postal Administration. All have in common the obligation to redeposit almost all the funds they receive with the "*Caisse des Dépôts et Consignations*", which uses such funds chiefly for purchasing government securities, but also employs a part of them—together with funds received from other sources, such as the social-security system and other insurance agencies—to grant loans to local authorities. Since the middle of 1950 the "caisses d 'épargne" have been able to require the "Caisse des Dépôts et Consignations" to use one-half of their new deposits for loans to local authorities designated by them.

That part of the resources of the "caisses d'épargne" which remains under their own direct control is also used to grant loans to local authorities.

The "*Crédit National*" was established soon after the first world war to facilitate the payment of war-damage indemnities and to help finance reconstruction by the issue of bonds. Later it was entrusted with other tasks and at present it plays quite an important rôle in the medium-term sector, using funds received from the "Fonds de développement économique et social" or raised on the capital market.

The "*Caisse Nationale des Marchés de l'Etat*" is a government agency whose main purpose is to assist government contractors, in various ways, to mobilise their claims on the Treasury. It does not grant credit directly itself.

The *postal-cheque system* is gaining in importance. On 31st October 1956 the total of sight deposits with the postal-cheque system amounted to nearly Fr. fcs 540 milliard; i. e., about one-fifth of the combined sight deposits of all banks.

Since 2nd December 1954 the official discount rate has been 3 per cent. (on rediscounts above the "ceiling" 5 per cent.) and the lombard rate 4½ per cent.

As to the rates which the banks charge their customers, *minimum charges* are fixed by "Conseil National du Crédit" in consultation with a banking commission. These minimum charges—to which taxes amounting to nearly 10 per cent. have to be added—were as follows at the end of 1955:

	Per cent.
Discounting of trade bills (3-month)	3.6
Acceptances (3-month), internal trade	6.0
Overdrafts	6.6

The *actual cost* of borrowing short-term funds is reported to amount to as much as 6 per cent, for trade bills and about 7 to 8 per cent. for overdrafts.

In the medium-term sector a variety of institutions grant special loans at differentiated privilege rates ranging from 2 per cent. on loans made out of funds supplied by the Treasury (either directly or via the "Fonds de développement économique et social") for agricultural investment, the construction of cheap houses under the H. L. M. scheme, etc., to 7 per cent. on loans granted directly by that Fund for industrial investment.

The charge on the normal long-term loans of the "Crédit Foncier" is 7.4 per cent. Smaller institutions are reported to be charging more than 10 per cent. on medium-term mortgage loans.

Privilege rates are also supplied to some types of export credits (medium-term), with the result that their overall cost is below 5 per cent. Consumer credit, as in other countries, costs much more, ranging from 15 to 20 per cent. in the case of motor-cars to 20 to 30 per cent. in the case of sewing and washing machines and refrigerators.

The rates paid by the banks on deposit accounts vary between ½ and 1½ per cent. for sight deposits (the large banks in Paris allowing ½ per cent.) and between 2¼ and 3¾ per cent. for time deposits at from two months' to two years' notice. Higher rates (up to 5 per cent), are, of course, paid on savings bonds of various types with a maturity of from one to five years. All these rates are maximum rates fixed by agreement.

In the money market, three-month Treasury bills are issued at 2½ per cent., and call money costs (October 1956) about 3½ per cent. Capital-market rates are about 5½ per cent. on long-term state securities and 6¼ per cent. on industrial bonds. The cost to the large private borrower, however, when issuing bonds, is at least 7 per cent.

France: Main rates paid and charged by credit institutions (including commission, etc.)

[In percentages]

Items	Central bank	Commercial banks	Other credit institutions
Rates paid on—			
Sight deposits		½ to 1½	
Time and savings deposits		2¼ to 3¾	2¼ to 3¾.
Rates charged on—			
Trade bills (discounting)	3	4½ to 6	
Secured advances	4½	6½	
Overdrafts		7 to 8	
Medium-term loans			6 to 9.
Mortgage loans			7½ to 10.

TAXATION*

The tax system of France is very complex and subject to frequent changes; consequently, no simplified synopsis could be relied upon for determining the amount of taxes for which a particular individual or firm is liable. The following brief summary, therefore, is given merely as an indication of the types of taxes that are payable in France. Some of these taxes, like the corporation registration tax, are comparable with payments which in the United States are regarded as fees.

In France, as in the United States, there are (1) taxes payable by an enterprise as such—for example, the corporation income tax and the wage tax (the latter is mentioned in the preceding section); (2) taxes payable by an enterprise in its capacity as a collection agent for the Government—for example, when the corporation withholds the proportional income tax from the dividends it distributes to its stockholders; and (3) taxes payable by an individual direct, as the personal income tax.

Corporation Tax

Upon its organization, the corporation pays a registration tax (or fee) based on the amount of its capital. The rate is 1.60 percent of the capital, except that on the real property portion of its capital an additional 0.5 percent is levied. Upon new stock increase of its capital, the rate is also 1.60 percent, but on increase of capital from accumulated reserves the tax is 7.2 percent.

License Tax (Patente)

The practice of industrial, commercial, and noncommercial (medical doctors, architects, etc.) activities in France is subject to annual license tax, the so-called "patente" tax (having nothing to do with "patent" as this term is used in the United States). The tax is due by the mere fact that a business office is located in France. It includes: (1) A flat tax, varying according both to the size of the municipality in which the business or profession is practiced and to a classification of these activities; and (2) a proportional tax based on the rental value of the premises and installations used in the business or profession.

Income Tax on Corporation Profits

Corporations (and certain other forms of business organizations which for tax purposes elect to be treated as corporations) pay a tax on net profits which, beginning with the income earned in 1955, is calculated at the rate of 45.60 percent.

*Excerpt from U. S. Department of Commerce, Bureau of Foreign Commerce, Establishing a Business in France, World Trade Information Service, pt. 1, No. 58–9 (January 1958).

Wage Tax and Social Security Contributions

The corporation, like other employers, pays a wage tax equal to 5 percent of the wages, salaries, and allowances paid to employees. The social security contributions referred to in the section, "Social Insurance," are based on the gross payroll.

Tax on Dividends, Interest, Bonuses

This tax is paid by the corporation in its capacity as a collection agent for the Government. It is withheld and paid by corporations liable to the tax on industrial and commercial profits. The normal rate is 18 percent of the dividends paid to shareholders, interest paid to bondholders, and bonuses paid to the members of the board of directors. The proportional income tax under which the above rate is applied to the withholding tax was increased by 10 percent under a law enacted in June 1956 on incomes from dividends and other intangibles and on other incomes exceeding 440,000 francs a year. At the time of this writing it is not clear just how this increase in the rate will be applied to incomes subject to it.

According to article 15 of the Franco-American Treaty, July 25, 1939, such tax is calculated for an American company doing business in France on three-fourths of the profits actually derived from the commercial transactions of its French branch.

Income Tax on Noncorporation Business Profits

Income from business profits other than corporation profits is subject to the personal income tax. This tax is discussed in the section, "Taxes on Personal Income."

Turnover Taxes

This category of taxes (Taxes sur le Chiffre d'Affairs) includes a variety of indirect taxes, of which the three most important are the value-added tax, the services tax, and the local tax. These taxes are also payable, where appropriate, on transactions involving imports in addition to customs duties.

Value-added tax (*taxe sur la valeur ajoutee*).—This tax is essentially a tax on the value added in the course of production of a commodity. However, in addition to manufacturers, the wholesale distributors, as well as in some cases chain stores, also pay this tax. The normal rate is 19.5 percent, but in certain cases a reduced rate of 12 percent or 10 percent is applied. A special rate of 27.5 percent applies to luxury products.

The tax is calculated on the sales price (including the tax, making it a tax on the tax) charged by the manufacturer or distributor to his customer, but in paying the tax he can deduct the amounts paid in added-value or services tax in the previous stage of production on the material used in his product. The basic principle of this tax is that it is paid only once upon any given article. When the product is the result of several operations executed by different firms, each stage in the chain of production is subject to the tax, but only on the value added in any given stage.

Services tax (*taxe sur les prestations de services*).—This tax is levied on a great many services, including services furnished by barbers, advertising, and others. The rate is 15.5 percent of the charges for these services.

Local tax (*taxe locale*).—This tax is generally assessed on all sales not subject to the value-added tax or the services tax. The rates vary from 2.2 percent to 2.75 percent except in a few cases such as exhibitions, hotels, etc., on which the rate is 8.5 percent.

Miscellaneous, Indirect Taxes

France has numerous other indirect taxes levied on specific products, as well as stamp taxes on documents. Some of these specific taxes are special purpose levies, as for example the 0.75-percent levy on textiles (assessed on the same basis as the value-added tax) for the encouragement of textile fiber production.

Taxes on Personal Income

Personal income tax in France consists of a flat-rate proportional tax and a progressive surtax.

Proportional tax (*taxe proportionnelle*).—The proportional tax is generally assessed on the various categories of income earned by individuals: Real estate rents, industrial and commercial profits, agricultural profits, and noncommercial profits (on personal property). Wages and salaries are currently exempted from the proportional tax, in lieu of which a payroll tax of 5 percent is paid by the employer.

The rate of the proportional tax has been 18 percent, but under new legislation (enacted in June 1956) the rate is increased to 19.8 percent. When the taxable income is from United States sources, it will be included in the income subject to the proportional tax only if the taxation on such income is incumbent on France, depending on the terms of the Franco-American double-taxation agreement of January 1, 1945. This applies also to income derived from American securities, debts, and trusts. However, the tax on such income is reduced by 15 percent, according to a provision of the agreement, in consideration of the tax already paid in the United States on the same income.

Graduated surtax (*surtaxe progressive*).—In principle, the graduated surtax is levied on the total income of individuals who are residents of France according to the definition given in article 4 of the General Tax Code. According to this article, the following persons are considered "residents": (1) Persons disposing in France of a dwelling as proprietors, usufructuaries, or tenants (in the latter case, the tenancy must be established by a single contract or successive contracts for an uninterrupted period of 1 year at least); and (2) persons who do not dispose of a dwelling in France, but who, nevertheless, have their principal place of abode in France.

However, under article 164 of the General Tax Code, the surtax will be assessed differently, depending on whether the interested persons are considered as having their "domicile" or only their "residence" in France. Foreigners "having the center of their interests" in French territory, or having habitually resided there, i. e., effectively for more than 5 years, will be considered as domiciled in France.

Foreigners who are held to be domiciled in France, in accordance with the preceding provisions, are liable to the graduated surtax on their total income, whatever may be its nature and origin. However, no tax will be levied on that portion of their income of foreign origin on which the taxpayers can prove that they have paid a personal income tax to their home country. As a consequence, the surtax is not due on income received in the United States which has already been taxed by the United States Government, provided that the recipient of such income is a United States national.

On the other hand, a person whose domicile is not in France, but who maintains there one or several residences, pays a tax calculated on the basis of an income equal to five times the amount of the rental of such residence or residences. However, if the income thus estimated is less than his total income of French origin, it is the latter which will be taken into consideration for the assessment of the tax.

The surtax is levied on income in excess of 220,000 francs a year. Until the legislation enacted in June 1956, the percentage rates on income were:

	Income (thousand francs)	
	From—	To—
Percentage:		
10	220	350
15	350	600
20	600	900
30	900	1,500
40	1,500	3,000
50	3,000	6,000
60	(1)	(1)

[1] On all incomes over 6,000,000 francs.

For single persons not heads of families or having dependents the last two rates (50 percent and 60 percent) are increased to 55 percent and 70 percent, respectively.

Under the legislation enacted in June 1956 this tax, beginning with the rates applicable to income over 600,000 francs, is increased by 10 percent.

In calculating the amount due under the progressive surtax, the income of the whole family is combined. In applying the above surtax rates (plus 10 percent on income in excess of 600,000 francs), however, allowance is made for the family status of the taxpayer by dividing this income in accordance with a schedule of units for calculating the amount of tax due. The amount of tax so obtained on this reduced income is then multiplied by the number used for dividing his income.

By this method the income is taxed at lower rates than if it were taxed as one unit. For example, a single person with no dependents cannot divide his income for tax purposes. But if he has a dependent, he is entitled to do so by two. A married person with 2 children is entitled to divide his income for surtax purposes by 3. He would thus compute his income of, say, 1,230,000 francs as follows:

$$\frac{1{,}230{,}000}{3} = 410{,}000 \text{ francs}$$

On first 220,000 francs	no tax
Between 220,000 and 350,000 francs, 130,000 × 10% =	13,000
Between 35,000 and 410,000 francs, 60,000 × 15% =	9,000
Total tax in francs per unit of income	22,000
Total tax in francs on all 3 units of income (22,000 ×3) =	66,000

GERMANY

CENTRAL BANKING IN GERMANY*

1. Historical Setting

The conflict between the forces of federalism and centralism has been a major element in shaping the political life and institutions of Germany during the past one hundred years, and the history of the central bank reflects this continuing struggle. When, in 1876, the first full fledged central bank—the Reichsbank—was formed, the centralists won a victory; but the federalists were sufficiently powerful to maintain the right of certain other banks to continue to issue notes. Not until 1935 did the Reichsbank obtain the sole right of note issue. The Reichsbank survived the First World War and the inflation in 1923; and in the following year, under the auspices of the Dawes Commission, it was reorganized, partly to make it more independent of the Government. In 1948, a new central bank, the Bank deutscher Laender, which incorporated more of the federal features than its predecessor, was organized as an interim bank, pending the founding of the new German State. In August 1957 the Bank deutscher Laender was reorganized into the somewhat more centralized Deutsche Bundesbank, but without losing all of its federal features.

2. Ownership and Control of the Central Banking Institution

The Central Bank Council, which determines the monetary and credit policies of the Bundesbank, consists of the President, the Vice President, the Directorate (responsible for administering and managing bank policies), and the Presidents of the Land Central Banks. (These banks act mainly as branches of the central bank, except for certain transactions with local governments and local banks.) The President and Vice President and the other members of the Directorate, who cannot exceed eight in number, are appointed by the President of the Republic after consultation with the Central Bank Council.

The capital stock, amounting to DM 290 million, is owned by the Federal Government. The net profit of the Bundesbank is divided as follows: 20 per cent of the profit or DM 20 million, whichever is higher, must be transferred to the legal reserve until the latter amounts to 5 per cent of the note circulation. Up to 10 per cent of the remainder of the profit may be used to constitute other reserves, which, however, cannot exceed the amount of the original capital. DM 40 million (DM 30 million beginning in 1980) are to be transferred annually to a special fund for the purchase of equalization claims (certain debts of the Federal Government) until that fund is wound up. Any remaining profits are transferred to the Federal Government.

*Prepared at the request of the Joint Economic Committee by the Division of International Finance, Board of Governors of the Federal Reserve System, Washington, D. C.

3. Relationship of the Central Bank to the Government

The Bundesbank is by law an autonomous Federal institution. The law states that the bank "in so far as is consistent with its functions, shall be bound to support the general economic policy of the Federal Government," but that in the exercise of its legal powers it "shall be independent of instructions of the Federal Government." Members of the Federal Government are entitled to take part in the deliberations of the Central Bank Council, but they have no vote, and the extent of their power is to delay decisions for as long as two weeks. The Bundesbank is prohibited by law from purchasing obligations of the Federal Government and its agencies in excess of prescribed limits.

4. Relation of the Central Bank to the Commercial Banks

The central bank does not normally deal directly with the general public, but only with credit institutions and certain public agencies in Germany as well as various international institutions.

5. Power of the Central Bank Over the Instruments of Monetary Policy

A decision to lower the discount rate—as well as any other decision—is taken by simple majority vote of the members of the Central Bank Council. Minimum reserve requirements for credit institutions may be established at any level by the Bundesbank up to a maximum of 30 per cent for sight liabilities, 20 per cent for time liabilities, and 10 per cent for savings liabilities. Open market operations may utilize certain bills of exchange, Federal Treasury bills and bonds, and other bonds admitted to the official stock exchange. Normally, only Treasury bills and bonds are used. In 1956–57 there were very large open-market sales by the central bank to absorb much of the bank liquidity arising from heavy inflows of foreign exchange.

6. Channels or Sources Supplying Business Capital

The Bundesbank does not and legally cannot finance the capital development of business. Two Government institutions, the Credit-Anstalt fuer Wiederaufbau (Reconstruction Finance Corporation) and the Industrie KreditBank (a semi-official agency utilizing both public and private funds) engage in this kind of operation. A rough division of the source of funds for the financing of small business would be one-third internally financed, one-third from the big commercial banks or the institutions mentioned, and one-third from the local county or municipal banks.

STRUCTURE OF THE GERMAN CREDIT SYSTEM*

The banking system in western Germany, which was reorganised and decentralised after the war, is now undergoing a process of re-centralisation. The *Bank deutscher Länder* has the right to fix and make changes in the discount rate but has no authority to prescribe bank liquidity ratios other than the minimum reserve requirements. It has, however, laid down so-called guiding principles with regard to credit-granting by the banks, the observance of which may be made a condition for the extension of central-bank credit. The Bank deutscher Länder also has authority to undertake open-market operations as a means of implementing its policies and since mid-1955 it has been technically in a position to operate in the open market on a substantial scale.

The German *commercial banks* can be divided into four groups:

(*a*) *The successor banks.*—These banks came into being when the former "three big banks" (the Deutsche Bank, the Dresdner Bank and the Commerzbank) were each split up into nine regional institutions; in 1952 these banks were regrouped in such a way that there are now legally nine of them in all. The total deposits of these "big banks" exceed those of all the other commercial banks taken together and their total assets at the end of November 1956 amounted to DM 16.7 milliard.

(*b*) *The state, regional and local banks.*—There are about eighty of these banks altogether, with over 1,200 branches; they handle about one-third of all commercial banking business and their assets total DM 13.2 milliard (November 1956).

(*c*) *Private banks.*—There are more than 200 of these and their balance-sheet total exceeds DM 3.2 milliard.

(*d*) *Specialised commercial banks.*—The balance-sheet total of these banks accounts for only DM 880 million, i. e. 2.5 per cent., of the combined balance-sheet total of all the commercial banks.

In Germany an important rôle is played by the *savings banks and their central institutions.* The volume of funds (mostly savings and long-term funds) received by these banks via their branches, of which there are over 8,800, is much larger than the amount received by the commercial banks.

Other credit institutions include a very large number of *agricultural and industrial credit co-operatives* with their central organisations, and there are also the *mortgage banks, building and loan associations,* etc.

A description of four special credit institutions which were all either created or reorganised after the monetary reform completes this brief account of the German credit system:

*Bank for International Settlements, Monetary and Economic Department, "Credit and Its Cost" (CB 268), Basle, Switzerland, January 1957.

(*a*) *The Landwirtschaftliche Rentenbank.*—This bank grants, through the intermediary of other credit institutions, short, medium and long-term credit to farmers and traders in farm products to supplement the funds which these can obtain from various smaller institutions. Its resources are derived from a compulsory contribution levied on real estate, from the issue of bonds, from allocations out of public budgets and, also, temporarily, from the use of counterpart funds.

(*b*) *The Kreditanstalt für Wiederaufbau.*—This organisation was founded with the specific object of enabling the basic industries to rebuild damaged plant, to modernise their existing equipment and to increase their productive capacity by granting them medium and long-term loans (in so far as they are unable to obtain sufficient funds from other credit institutions or on the capital market), the funds lent being paid out through the agency of the borrower's bank. The Kreditanstalt can issue bonds, borrow funds directly and utilise specially allocated counterpart funds.

(*c*) *The Industriekreditbank.*—This bank provides industrial enterprises with medium and long-term credit. Though it is authorized to issue bonds, it has up to the present acted mainly as a technical agent for the distribution of counterpart funds and of funds derived from a special contribution (Investitionshilfe).

(*d*) *The Lastenausgleichsbank.*—This bank grants loans to refugees' enterprises through other credit institutions. Its resources are derived mainly from public budgets (a special tax being levied for this purpose).

Main items of the balance sheets of German credit institutions at the end of 1955 (excluding interbank accounts and the central-banking system)

[In millions of deutschemarks]

Items	Commercial banks	Savings banks [1]	Other credit institutions [2]	All credit institutions
Sight deposits	8.2	5.5	3.4	17.1
Longer term funds (time deposits, savings deposits, borrowed funds) [3]	11.6	23.1	26.3	61.0
Total	19.8	28.6	29.7	78.1
Lending to the private economy:				
Short-term lending (discounts and advances, including bills rediscounted)	16.9	5.6	5.2	27.7
Investments (mortgage loans, private securities, etc.)	6.9	15.4	15.8	38.1
Total	23.8	21.0	21.0	65.8

[1] Including central giro institutions.
[2] Mortgage banks, cooperative banks and credit institutions with special functions.
[3] Loans taken up for more than 6 months and bank bonds issued.

Although the German commercial banks are not required by law to limit their operations to short-term lending, they do, in fact, grant mainly short-term loans, as can be seen from the table. The savings banks and other credit institutions, on the other hand, lend a very large proportion of their resources at long term.

The Bank Supervisory Authorities fix the maximum rates of interest and commission to be charged in the various Länder. Firms whose solvency is particularly good are often charged lower rates of interest—as was the case, in particular, from the summer of 1954 until the autumn of 1955—but medium-sized business firms still pay the maximum rates. All rates are linked to the official discount and lombard rates, which on 6th September 1956 were both lowered by ½ per cent., to 5 and 6 per cent. respectively.

The overall charges (maximum) for the most important types of short-term business credit are as follows:

	Per cent.
Trade bills	7–9
Acceptances	8½
Advances	9½
Overdrafts	11–12

Advances and overdrafts are also subject to a turnover commission, which varies according to the Land concerned.

It has been estimated that medium-term bank loans cost between 9 and 10 percent.

Longer-term loans are somewhat cheaper than medium-term loans owing to the fact that the collateral security provided is usually better. The rates charged for mortgage loans are as follows:

	Per cent.
Mortgage loans:	
Agriculture:	
Normal	8–9
Special	5–6
Housing:	
Normal	7–9
Special	6¼–7
Industry: Normal	8½–9

Among the credits which enjoy privileged treatment, mention should be made of rediscountable bills in foreign currencies deriving from exports, which cost only between 4½ and 5½ per cent., of medium-term loans extended to German firms for the purpose of enabling them to grant increased facilities to their foreign customers, which cost 6½ to 8½ per cent., and by "reconstruction loans", the overall cost of which does not exceed 7½ per cent.

The banks pay the following rates on deposits:

	Per cent.
Sight deposits	1¼–1¾
Time deposits	4¼–5¾
Savings deposits	3½–5½

Smaller credit institutions are allowed to charge and pay slightly higher rates.

It is difficult to assess the average yield of long-term bonds in Germany. During the first nine months of 1956 about 50 per cent. of the total of DM 2.38 milliard of new issues were made at a nominal rate of 6 per cent., while the average selling price was generally 98 per cent. There has been an increase in rates on the capital market, and money raised in this market by an industrial concern of good standing, which up to the end of 1955 would have cost, say, about 7 to 8 per cent. altogether, is now likely to cost 9 to 9½ per cent.

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In the money market proper, daily money rates were about 4¾–5 per cent. or more at the beginning of December 1956, while the Bank deutscher Länder's selling rate for Treasury bills maturing within 60 to 90 days was raised to 4¾ per cent. on 4th December 1956.

Germany (Federal Republic): Main rates paid and charged by credit institutions (including commission, etc.)[1]

[In percentage]

Items	Bank deutscher Länder	Other banks
Rates paid on—		
Sight deposits	----------	1¼–1¾
Time and savings deposits	----------	3½–5¾
Rates charged on—		
Trade bills (discounting)	5	7 –9
Advances	6	9½
Overdrafts	----------	11 –12
Medium-term loans	----------	9 –10
Long-term loans (normal mortgages)	----------	7 –9

[1] The official discount rate was lowered from 5 to 4½ per cent. on Jan. 11, 1957.

TAXATION*

Almost all taxes in the German Federal Territory are regulated on a uniform basis by Federal law, regardless of whether they are collected on behalf of the Federal Republic, the Laender, or the local governments. A few taxes with localized application are the only exceptions. Taxes are payable in German marks.

Income Taxes

Scope of tax liability.—A distinction is drawn between unlimited and limited income tax liability. A person who has his residence in the territory of the Federal Republic is subject to unlimited income tax liability, i. e., he is subject to income taxes on all of his taxable income regardless of whether it is earned within or without the territory of the Federal Republic. On the other hand a person who does not have his residence in the territory of the Federal Republic is subject to limited income tax liability, i. e., he is subject only to income taxes on taxable income earned within the territory of the Federal Republic. Persons who are subject to limited tax liability are assessed as "married" (class II, German Income Tax Law), but the tax is set at least at 25 percent of the income. Their income derived from wages, salaries, and dividends, etc., is not assessed with their income from other sources, but is taxed separately.

After residing 6 months in Germany, foreigners become automatically subject to unlimited tax liability. In instances in which foreigners become subject to unlimited income tax liability, the Land (State) tax authorities can fix an annual lump sum payment for a period of 10 years. The lump sum can be fixed for the income within Germany as well as for the income earned in other countries. A lump sum settlement may be applied particularly if it is desired for specific economic reasons or if it proves to be too difficult to determine the taxable income earned abroad. In cases in which the German Government takes special interest in the foreign investment or in the personal activity of the foreigner for economic or cultural reasons, the lower foreign tax rate may be applied, but in no case may the rate be lower than 50 percent of the German rate.

The owners or leading officials of an enterprise which has its head office in Germany can be made subject to unlimited tax liability, even though they have their residence abroad, if they are actually directing the business in Germany.

Taxable income.—The income tax is levied on income earned during the calendar year. Subject to income tax is income from agriculture and forestry enterprises, business enterprises, wages and salaries, independent work, property, rents, interest, and dividends. Income in-

*Excerpt from United States Department of Commerce, Bureau of Foreign Commerce, "Establishing a Business in Germany," World Trade Information Service, Part I, No. 57–82 (December 1957).

cludes the total of all incomes after compensation for losses and after deduction of special expenses. Losses can be carried over for a period of 5 years. Capital gains are taxed as a general rule only if they are derived from professional trades (i. e., capital gains from security sales of a broker). All capital gains from the sale of securities are taxed, however, if the time between purchase and resale of the securities is less than 3 months.

Tax classes and rates.—Under German income tax law, tax rates differ depending on whether the taxpayer belongs to class I, class II, or class III. The class is determined by reference to age, marital status, number of children, etc. The bracket rates which are applied on taxable income reach 63.4 percent at the level of DM605,001 per year (see following table). The nominal top rate on total income is 55 percent; in other words, income taxes shall in no case exceed 55 percent of total taxable income. The tax administration is comparatively liberal in the interpretation of allowable deductions for all types of expenditures directly or indirectly connected with business enterprises. Declared business expenses are deductible up to the full amount.

Amounts of Income Tax Payable in Federal Republic of Germany on Selected Incomes, by Tax Class [1]

[In German marks]

Taxable income	Tax class		
	I [2]	II [3]	III/2 [4]
1,150		1,583	1,056
10,000	1,817	4,545	3,843
20,000	4,846	12,270	11,341
40,000	12,664	20,731	19,792
60,000	21,123	29,708	28,715
80,000	30,122	39,119	38,084
100,000	39,551	(5)	(6)
200,000	88,261 plus 53.9 % of amount exceeding 195,001	(5)	(6)
300,000	143,892 plus 57.3% of amount exceeding 295,001	(5)	(6)
400,000	202,466 plus 59.8% of amount exceeding 395,001	(5)	(6)
600,000	325,700 plus 63.3% of amount exceeding 595,001	(5)	(6)
Over 614,000	55% of taxable income	(5)	(6)

[1] The law on tax preferences for Western Berlin enacted in the spring of 1955 provides for a 20-percent reduction in personal and corporation taxes on incomes earned in Western Berlin, as of January 1, 1955.
[2] Unmarried, up to age 55.
[3] Married, no children; unmarried, age over 55.
[4] Married, with 2 children.
[5] Same rate as for class I but computed on the taxable income reduced by DM900 for the taxpayer.
[6] Same rates as for class I but computed on the taxable income reduced by DM900 for the taxpayer and DM720 for the first and DM1,440 for the second child.

Source: Bundesgesetzblatt 1956 I, p. 781; and 1957 I, p. 848.

Personal exemptions.—The annual tax-free income amounts to DM900 each for the taxpayer and wife, DM720 for the first and DM1,440 for the second child; and DM1,680 for each child from the third on.

Unmarried taxpayers over 55 years of age receive an exemption of DM1,800. For calendar year 1957, unmarried taxpayers over 70 years of age received an additional exemption of DM360. Married taxpayers and unmarried taxpayers belonging to tax class III were granted an additional exemption of DM720 if over 70 years of age. Married couples not continuously separated were granted only one such addition exemption.

For calendar year 1957, DM600 were deducted from taxable income of one part of the married couple if the other part does not earn taxable income.

Owners of business enterprises including professionals (physicians, lawyers, etc.) may deduct from their income before tax business losses incurred during the preceding 5 business years unless such losses were taken into account in assessments for these years.

Special exemptions designed to offset extraordinary financial burdens imposed on taxpayers may be granted upon application. The special exemption provisions do not apply to persons who are subject only to limited tax liability.

Depreciation.—Amounts for depreciation are deductible in a manner similar to that provided in the Internal Revenue Code of the United States. However, expenses incurred for so-called short-life assets, i. e., assets for which a price of DM600 or less has been paid, can be fully deducted from income in the year of acquisition.

In addition, special depreciation allowances may be granted by Federal ordinance for stockpiles of certain imported goods. These allowances may amount to 15–30 percent of the acquisition or market price, whichever is lower. Special allowances may also be granted for extension and development projects of underground mining of bituminous coal, brown coal and ore, and of surface mining of brown coal and ore. These allowances may amount to 50 percent for movable fixed assets and to 30 percent for immovable fixed assets and are granted for the first 5 years after acquisition; the development projects must be approved by the pertinent Land Economics Ministry and initiated prior to January 1, 1961.

In addition to normal depreciation allowances on movable fixed assets (machinery, etc.), persons persecuted under the National Socialist regime and expellees may deduct 50 percent in the first 2 years after acquisition up to an annual amount of DM100,000. They also enjoy an additional depreciation allowance of up to 10 percent of the cost of business constructions erected after December 31, 1951 (factory buildings, warehouses, etc.). The same group of persons can also deduct, from income before tax, 75 percent of reinvested profits up to an annual total amount of DM20,000.

In addition to normal depreciation allowances for ships, up to 15 percent can be deducted in the first 2 years after acquisition (construction) if the ships were acquired (or constructed) after December 31, 1948.

From the expenses for housing units, 10 percent can be deducted from income before tax in the first 25 years after construction under the following conditions:

1. Constructed between December 31, 1948, and December 31, 1952, and used to at least 80 percent for dwelling purposes;

2. Constructed after December 31, 1952, and used to at least 66⅔ percent for dwelling purposes.

Privileged expenditures.—Twenty-five percent of interest-free loans to housing projects for the employees of the taxpayer are deductible from income before tax up to DM7,000 for 1 housing unit (for certain types up to DM10,000). The loan must be granted for a period of at least 10 years and must be repayable in equal annual installments. There is no limit as to the total amount to be deducted for such purposes. Twenty-five percent of interest-free loans to other housing projects are deductible under the same conditions up to a total amount not exceeding 30 percent of total annual income.

Contributions for charitable and religious purposes are deductible up to 5 percent of total income or 0.2 percent of total turnover plus wages and salaries disbursed during the calendar year. Contributions for scientific and political purposes are deductible up to 10 percent of total income. This provision does not apply to persons subject only to limited income tax liability.

Other privileged expenditures (savings, purchases of building and loan shares, insurance premiums, and other officially indorsed investments) are now fully deductible up to DM1,000 for the taxpayers, DM1,000 for his wife, and DM500 for each additional dependent (child).

Income from interest and dividends.—Income derived from dividends is, in general, subject to a 25-percent withholding tax which can be applied as a tax credit against the total income tax to be paid by the individual taxpayers on his total income including that derived from dividends. Income derived from interest enjoys special treatment depending on the type of securities.

Interest earned on the following securities is tax free:

1. Mortgage or communal bonds issued prior to January 1, 1955, provided that at least 90 percent of the proceeds from such securities are used for financing low-cost housing programs.

2. Fixed-interest-bearing Federal and Laender government bills and bonds with a minimum period of 3 years to maturity issued prior to January 1, 1955.

3. All fixed-interest-bearing securities (excluding registered bonds) issued before April 1, 1952, and all fixed-interest-bearing securities issued between March 31, 1952, and December 17, 1952, which are approved in accordance with the stipulation of the Federal Law on Capital Transactions. Furthermore, fixed-interest-bearing securities issued abroad by credit institutions which were recognized by December 17, 1952, as transferred to a place within the Federal Republic, or which had transferred their seat to a place within the Federal Republic before June 21, 1948, or to Western Berlin before June 25, 1948. These tax exemptions also apply to industrial bonds (excluding convertible bonds and income bonds, i. e., bonds whose rate of interest varies in accordance with the profit made by the pertinent firm) issued before January 1, 1952, provided that the interest rate does not exceed 5.5 percent.

4. Fixed-interest-bearing securities issued between March 31, 1952, and January 1, 1955, provided that the use of the proceeds from the sale of the bonds has been recognized by executive order as deserving support.

Furthermore, capital yields from dividends and other receipts from shares in housing enterprises due before January 1, 1959, provided that such enterprises are recognized as nonprofit enterprises under the Reich Law on Nonprofit Housing of February 29, 1940 (Gesetz ueber die Gemeinnuetzigkeit im Wohnungsbau).

Other bonds of State and local governments, and industrial bonds are subject to a 30-percent withholding tax (no additional income taxes) according to specifications in the income tax law.

Assessment.—Tax returns for income in the preceding calendar year must be filed every year by March 10 unless otherwise stipulated. Married couples may choose to be assessed jointly or individually. They may also choose whether the income of the husband or the wife shall be taxed at the rates of tax group I (single individuals).

Corporation Taxes

The corporation tax applies to corporations, limited liability companies, cooperatives, mutual insurance companies, other private juridical persons, associations, societies, foundations, institutions, and enterprises owned by public corporations which are operated for profit. As to Western Berlin, the law on tax preferences provides a 20-percent reduction on corporation taxes on income earned in Western Berlin, as of January 1, 1955.

A corporation is subject to unlimited corporation tax liability if it has either its seat or its management in Germany. In this case, its entire income is subject to corporation tax regardless of whether it is earned within or without Germany. On the other hand, corporations are subject to limited corporation tax liability if they have neither their management nor seat in Germany. In this case, only their income derived from sources within Germany is subject to corporation tax.

The base of assessment for the corporation tax is the same as for the personal income tax—a flat rate of 45 percent of undistributed profits. Exceptional rates are provided for certain types of corporations normally of no interest to American investors.

The 45-percent tax rate has been reduced to 30 percent on that part of taxable income of corporations distributed as dividends. However, in case of limited liability companies, the reduced rate of 30 percent does not apply to distributed income exceeding 8 percent of the paid-in capital.

In certain cases, a lump sum assessment may be accorded to foreign corporations under the same provisions as the personal income tax (see above).

Deductions for contributions to charitable organizations, etc., are treated the same as under the personal income tax with the sole exception that contributions for political purposes are deductible only up to 5 percent of total income (see above). Property tax and income taxes are not deductible.

Dividends from subsidiaries are not taxable when received by parent corporations subject to unlimited tax liability if the latter own at least one quarter of the stock of the subsidiary (so-called "Schachtel-Privileg").

In addition to the corporation tax, a special tax on behalf of Western Berlin (Notopfer Berlin) is levied on corporate income. (The rate is 4.09 percent of the annual income before tax but not less than DM240.)

Other Direct Taxes

Capital transactions taxes.—The capital transactions taxes are levied as follows:

1. The initial sale of newly issued domestic shares and similar equity titles in corporations, limited liability companies, and similar

companies is subject to the company tax (Gesellschaftssteuer). Contributions of investment and working capital by a foreign corporation in favor of a branch in the Federal Republic are also subject to taxation. The rate is 3 percent of the value of the capital transaction. Tax liability rests with the company receiving the funds.

2. The initial sale of newly issued domestic private bonds and the first domestic sale of shares and bonds issued abroad are subject to the securities tax (Wertpapiersteuer). The rates range from DM0.075 to DM0.30 per DM10 of the nominal value of the securities sold. For foreign securities, the rate is based on the market value. Tax liability rests with the seller.

3. Transactions in securities (except initial purchase) in the Federal Republic and Western Berlin are subject to the stock exchange turnover tax (Boersenumsatzsteuer). Transactions in securities abroad are also subject to this tax if at least one German resident is participating. The tax rates range from DM0.03 to DM0.075 per DM100, of the transaction value according to the type of security. Tax liability rests with both purchaser and seller. The tax rate is reduced by 50 percent for German residents participating in transactions abroad.

Taxes on real estate.—All purchases of real estate are subject to the real estate purchase tax (Grunderwerbssteuer). The tax rate is generally 7 percent.

There is also an annual real estate tax (Grundsteuer) levied as a special property tax on the owner of real estate. The rate is set by the local governments and differs slightly in the various cities and counties. The average rate is between 2 and 3 percent of the value of the real estate.

General property tax.—All property, including real estate, is subject to a general property tax (Vermoegensteuer) at an annual rate of 1 percent. The tax applies to all property held inside or outside of Germany when the owner has his residence or usual stay—in case of a corporation, the main office—in the Federal Republic of Germany or Western Berlin. For nonresidents only the property held in the Federal Republic and Western Berlin is liable to the property tax. Natural persons maintaining permanent residence in Germany enjoy an exemption of DM10,000, an additional exemption of DM10,000 for a wife, and a further exemption of DM5,000 for each child under 18 years of age.

Trade tax.—All business enterprises in Germany are liable to local government trade taxes (Gewerbesteuer). The tax is levied on business income and on business capital. While rates differ in the various cities and counties the average trade tax burden has been estimated to amount to about 14 percent of the business income liable to income tax.

Some local governments also levy taxes on the total amount of monthly (or quarterly) wages (Lohnsummensteuer) paid by an enterprise. In some cities an additional tax is imposed on the number of branches of banks and retail stores (Zweigstellensteuer).

Excise and Other Indirect Taxes

The most important indirect tax is the turnover tax (Umsatzsteuer) imposed on transactions in goods and services. As a rule, all transactions are subject to this tax. However, the Turnover Tax Law

(Bundesgesetzblatt I, September 1, 1951, p. 791) and implementing regulations provide for numerous exemptions for various types of goods and services under circumstances specified in the regulations.

A turnover equalization tax (Umsatzausgleichssteuer) is levied on imports in order to impose on these imports the same burden of turnover tax which rests upon the same goods if procured in Germany.

Excise taxes are levied on sugar, beer, salt, alcohol, coffee, matches, tea, illuminants, lighting fixtures, playing cards, lottery tickets, beverages, tobacco, petroleum and petroleum products, vinegar, champagne, and transportation.

THE DEUTSCHE BUNDESBANK'S CREDIT AND FOREIGN EXCHANGE POLICY REGULATIONS AT PRESENT IN FORCE*

1. Credit Policy Regulations

PRINCIPLES FOR ELIGIBILITY OF CREDIT INSTRUMENTS AT THE BUNDESBANK

(*a*) *Discount Business*

Bills of exchange presented for discount are to be backed by three parties known to be solvent. The bills must be payable within three months from the date of purchase. They should be good commercial bills (Article 19, paragraph 1 item 1, of the Law concerning the Deutsche Bundesbank).

For assessment of the soundnes of a signature the Central Bank Council has laid down the following ruling: any person who is liable on a bill which has been presented to the Deutsche Bundesbank for purchase or as security for an advance, and who despite being invited to provide information as to his financial affairs gives no information or no sufficient information, and with regard to whom there are otherwise available or procurable no data permitting adequate judgment of his financial affairs, is not to be regarded as a "party known to be solvent" within the meaning of Article 19, paragraph 1 item 1, of the Law concerning the Deutsche Bundesbank. A bill may not be purchased, nor may an advance be made against it, if it is clear that the acceptor cannot be regarded as a "party known to be solvent" (Decision of 20 February 1957).

Commercial bills are bought only if the period to their maturity does not extend beyond the time which is necessary for settlement of the underlying transaction in goods (Decision of 10 May 1949). Grain and fodder bills can however in principle be taken with a period to maturity of three months in order to facilitate the storage of grain and feedingstuffs at the marketing and processing stages, and thereby at the same time to reduce the demands for financial accommodation made on the central agencies (Decision of 31 July 1952).

Bills which are given for the purpose of financing instalment sales transactions are in principle excluded from discount (Decision of 21 March 1956). Instalment sales bills may however be purchased which serve to finance the purchase of agricultural machines that have a long life and assist production. In this exceptional case all bills which are due within 90 days are discountable if it is a case of an instalment sales transaction where the buyer has paid cash down for at least 40 percent of the purchase price, and the whole period for which the

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* Report of the Deutsche Bundesbank for the Year 1957, Chap. III, Part A, pp. 57–69. See in this connection the following: Annual Report of the Bank deutcher Länder: for 1948/49, pages 53 to 57; for 1950, pages 100 to 106; for 1951, pages 82 to 86; for 1952, pages 91 to 97; for 1953, pages 101 to 113; for 1954, pages 118 to 130; for 1955, pages 116 to 128; and for 1956, pages 114 to 127.

credit runs does not exceed 24 months. If such an instalment sales transaction does not fulfill these conditions, then the last bill only is eligible at the Bundesbank if it is due within 90 days, or, in the case of instalment sales transactions which are based on monthly instalments, the last three bills relating to the whole transaction are discountable.

Instalment sales bills which do not fall under the provisions for exceptions, but which relate to transactions that had already been concluded by 22 March 1956, can be purchased under the regulations which applied up till 21 March 1956. In addition instalment sales bills with a remaining life of not over 14 days may be presented for discount.

Bills which serve for the interim financing of building projects will not be purchased (Decision of 12 October 1955). This exclusion does not apply to building-material bills, that is bills drawn on the basis of building materials delivered by the producer to the trade, by the trade to the builder or building craftsman, and by the builder to the owner of the house (for repair or maintenance work). Prolongations of such bills however continue to be excluded from purchase.

Bank acceptances are purchased only if they serve to finance at short term specific individual transactions. They should be for at least DM 5,000 (Decision of 31 January 1951). For the purpose of encouraging the establishment of a market in prime acceptances the Land Central Banks may in cases where they deem it appropriate waive the declaration as to the underlying transaction, indicating the business financed by the bank acceptance (Decision of 14 April 1954). Bank acceptances which serve to finance capital investments or to render frozen debtors liquid are not purchased (Decision of 10 May 1949).

Since bank acceptances as a rule bear only two signatures when taken by the Land Central Bank, regard must be paid to the legal provision according to which the third signature may be dispensed with only if the security of the bill is guaranteed in some other way (Article 19, paragraph 1 item 1, of the Law concerning the Deutsche Bundesbank).

The guiding principles for the purchase of bank acceptances apply mutatis mutandis to the purchase of bills drawn by credit institutions on their debtors, subject to the proviso that the total amount of the bills drawn by a bank and relating to any one debtor should not exceed DM 20,000, and that no minimum amount is laid down (Decision of 31 January 1951).

Promissory notes of the Import and Storage Agencies, known as Storage Agency Bills, are deemed in virtue of special Decisions of the Central Bank Council to be purchasable within the meaning of Article 19, paragraph 1 item 1, of the Law concerning the Deutsche Bundesbank and the guiding principles in force for credits. They may be used in the regulating of the money market (see "Other Measures and Decisions in the Field of Credit Policy", Section b. The maximum limit for the circulation of Storage Agency Bills will from time to time be laid down in special agreements (Decision of 27/28 March 1958).

Also rediscountable are the bills drawn on themselves by German exporters, bearing the endorsements of the exporter's bank and of the

Ausfuhrkredit-AG (Export Credit Company), and necessary prolongations of the said bills, which have been issued for the purpose of financing export orders at medium or long term within the limit of a rediscount line accorded to the Ausfuhrkredit-AG (Decision of 5/6 March 1952). The rediscount line, known as Limit B of the Ausfuhrkredit-AG, amounts at present to DM 500 million (Decision of 20 February 1957). It may be used only for credits running for not less than one year and not more than four years (Decision of 6 February 1957). The exporter must as a rule himself participate to the extent of 40 per cent of the value of the order, either through use of his own resources or through recourse to his own bank (Decision of 6 October 1954). Only individual transactions may be financed. The financing assistance is intended in general to bridge over the interval between the time when production begins and that when the export proceeds are received. In case of the export of mass or series-produced goods which are produced within any manufacturer's normal production programme, or are sold ex warehouse, the duration of production and of warehousing must not be included in the period for which the financing assistance runs. For transactions of this kind, therefore, the Bundesbank's assistance is given only for the purpose of bridging over the period between despatch of the goods and receipt of the export proceeds (Decisions of 18 May 1956 and 25 July 1956). The rediscount line must not be used for the purpose of providing funds for capital investment or working resources for general export purposes of the exporting firms.

Export drafts have been no longer purchased since 1 December 1957, and their permissible prolongations since the end of February 1958 (Decision of 21/22 August 1957). For West Berlin an exceptional arrangement laid down in detail applies.

Under Article 19, paragraph 1 item 8, in conjunction with Article 22 of the Law concerning the Deutsche Bundesbank the Bundesbank is empowered to purchase directly, from physical and legal persons that are not credit institutions, bills of exchange and cheques expressed in foreign currency. At present the Bank is not making use of this power (Decision of 16 October 1957).

Foreign currency bills and cheques are purchased from credit institutions at the Deutsche Bundesbank's rate of discount (Decisions of 18 May 1956 and 22 January 1958). The governing rates for purchase are laid down in conformity with the prevailing forward rates, and are regularly published in the Bundesanzeiger (Federal Advertiser) (Decision of 21/22 August 1957).

(*b*) *Advances on Securities*

Advances on securities (interest-bearing loans against collateral for not more than three months) may be granted against pledging of the securities and claims on the Federal or Land Debt Registers listed in Article 19, paragraph 1 item 3, of the Law concerning the Deutsche Bundesbank. Detailed information regarding the assets eligible as security for advances, and the lending limits applicable thereto, is given in the "List of Securities Eligible at the Deutsche Bundesbank as Security for Advances" which is published in the Bundesanzeiger and the Bank's Notices.

The inclusion of a security in the above-mentioned list does not oblige the Bundesbank to grant advances, and does not limit the Bank's right to determine the cover to be provided by the borrower.

The question whether an advance against securities can be granted in an actual individual case will be decided according to the general credit situation and the individual circumstances of the would-be borrower. In principle an advance against securities is to be granted only where the object is to cover for a short period a temporary need for liquidity, and where in other respects there are no objections to the purpose of the borrowing (Decision of 17/18 December 1952).

Bills which cannot be purchased under the regulations in force are also in principle ineligible as security for advances (Decision of 10 May 1949). There is an exception in the bills drawn by German exporters on themselves and financed through the Ausfuhrkredit-AG's Limit A, which bills may be taken as security for advances but may not be purchased (Decision of 5/6 December 1951).

In other respects the "Deutsche Bundesbank's General Business Conditions" (VI. Advances) apply to the granting of advances on securities.

Notwithstanding the limitations under Article 19, paragraph 1 item 3, the Bundesbank may grant loans to credit institutions, insurance companies and building and loan associations against the pledging of Equalisation Claims within the meaning of Article 1 of the Law on the Redemption of Equalisation Claims,[3] in so far and so long as is necessary for maintaining the solvency of the pledger (Article 24, paragraph 1, of the Law concerning the Deutsche Bundesbank).

REDISCOUNT QUOTAS FOR CREDIT INSTITUTIONS

The extent of the recourse by credit institutions to the Deutsche Bundesbank is limited—apart from other effects of Central Bank policy—through individually proportioned rediscount quotas. The Central Bank Council has laid down standard quotas which, differentiated according to categories of institutions, are calculated on the basis of the "liable funds"[4] (Decisions of 17 April 1952, 15 December 1954 and 3 May 1957). The method of fixing the quotas contains sufficiently elastic elements.

The standard quotas were reduced by 15 per cent with effect from 1 May 1957. The reduction is also applied in the calculating of new standard quotas. From the reduced standard quota there is deducted the amount taken abroad of such credits as do not serve for the initial financing of an import or for carrying out a merchanting transaction (Decisions of 10 April 1957 and 3 May 1957).

The rediscount quota of any large bank with a branch system, or of any other supraregionally operating credit institution, will be fixed by the Land Central Bank in the area of which the head office of the institution in question is located (Decision of 17/18 September 1952).

[3] Law on the Redemption of Equalization Claims, of 14 June 1956 (Federal Law Gazette I, page 507).

[4] For a definition of "liable funds" see page 139.

The rediscount quotas of the following credit institutions, which have central functions for the whole area of the Federal Republic (Article 7, paragraph 1 item 2, of the Law concerning the Deutsche Bundesbank), will be laid down on the basis of the standard quotas by the Directorate of the Deutsche Bundesbank (Decision of 27/28 March 1958):

Ausfuhrkredit-Aktiengesellschaft, Frankfurt on Main
Deutsche Bau- und Bodenbank AG, Frankfurt on Main
Deutsche Genossenschaftskasse, Frankfurt on Main
Deutsche Girozentrale—Deutsche Kommunalbank, Düsseldorf
Deutsche Verkehrs-Kredit-Bank Aktiengesellschaft, Frankfurt on Main
Industriekreditbank AG, Düsseldorf
Kreditanstalt für Wiederaufbau, Frankfurt on Main
Landwirtschaftliche Rentenbank, Frankfurt on Main
Lastenausgleichsbank (Bank für Vertriebene und Geschädigte), Bad Godesberg

For the purpose of determining the extent to which any credit institution has used its rediscount quota the total amount of the bills that the credit institution has rediscounted and which are not yet due is decisive, this amount being known as the "Einreicherobligo".

Outside the fixed rediscount quota those bills drawn by German exporters on themselves may be purchased which are issued within the rediscount line of DM 500 million opened by the Bundesbank for the Ausfuhrkredit-AG for the purpose of financing medium and long-term export transactions.

The fixed rediscount quota must never be exceeded, not even temporarily. Credit institutions whose rediscount quota is exhausted may resort to advances against securities.

GUIDING RATIOS FOR CREDITS GRANTED BY CREDIT INSTITUTIONS

In order to bring the total amount and the structure of any credit institution's lendings into line with its financial capacities the Central Bank Council has established certain Guiding Ratios, on the observance of which the Bundesbank's assistance through rediscounting or similar operations may be made dependent.

There are four Guiding Ratios, namely:

Guiding Ratio I for the ratio of the lendings at short and medium term to the liable funds;
Guiding Ratio II for the ratio of the "debtors" to the total of liable funds and deposits;
Guiding Ratio III for the liquidity;
Guiding Ratio IV for the ratio of the acceptance credits to the liable funds.

OTHER MEASURES AND DECISIONS IN THE FIELD OF CREDIT POLICY

(a) Purchase of Equalisation Claims

Under the Law on the Redemption of Equalisation Claims[5] DM 40 million—and from the 1980 accounting year onwards DM 30 million—out of the Bundesbank's net profit are to be paid each year into the Fund for the Purchase of Equalisation Claims (the Purchase Fund), established as a juridically dependent institution of the Bundesbank. Equalisation Claims are bought to the debt of this Purchase Fund where their definitive acquisition seems desirable for the purpose of enabling the creditor institutions to fulfil matured obligations (loc. cit., Article 9, paragraph 1). So far as the resources of the Purchase Fund are not required for these purposes, the Bundesbank is to purchase Equalisation Claims of creditors who show in their balance sheet—by comparison with the balance sheets of creditors having an identical or similar business structure—a proportion of Equalisation Claims higher than the average (these operations being known as "equalising purchases"—loc. cit., Article 9, paragraph 2). Only then may the resources of the Fund be used to purchase Equalisation Claims of all creditors in a proportion to be determined as a uniform percentage (loc. cit., Article 9, paragraph 3).

In addition the Bundesbank may purchase for its own account from credit institutions, insurance companies and building and loan associations Equalisation Claims within the meaning of Article 1 of the Law on the Redemption of Equalisation Claims, subject to the provisions of Article 9, paragraph 1, of that Law, in so far and so long as the resources of the Purchase Fund are not sufficient for this purpose (Article 24, paragraph 2, of the Law concerning the Deutsche Bundesbank).

[5] Law on the Redemption of Equalisation Claims, of 14 June 1956 (Federal Law Gazette I, page 507).

Present Guilding Ratios in regard to Credits

Guiding Ratio	Commercial Banks [1]	Savings banks	Industrial Credit Cooperatives	Agricultural Credit Cooperatives	Central Giro Institutions	Central Institutions of Industrial Credit Cooperatives	Central Institutions of Agricultural Credit Cooperatives
I	The total of the short-term and medium-term lendings to business and private customers shall not exceed 18 times the liable funds of the commercial bank.[2]	The total of the short-term lendings to business and private customers shall not exceed 15 times the liable funds of the savings bank.	The total of the short-term lendings to business and private customers shall not exceed 15 times the liable funds of the industrial credit cooperative (plus the addition to these which is permitted by law).	The total of the short-term lendings shall not exceed 15 times the liable funds of the agricultural credit cooperative (plus the addition to these which is permitted by law).	The total of the short-term lendings to business and private customers shall not exceed 15 times the liable funds of the central giro institution.	The total of the short-term lendings to business and private customers shall not exceed 5 times the liable funds of the central institution of industrial credit cooperatives.	The total of the short-term lendings shall not exceed 20 times the liable funds of the central institution of agricultural credit cooperatives.
II	The debtors shall not exceed 60 per cent of the liable funds and deposits.[3]	The total of the debtors plus the bills drawn on debtors shall not exceed 60 per cent of the liable funds and deposits, the savings deposits being taken at the rate of only 50 per cent.	The total of the debtors plus the bills drawn on debtors shall not exceed 70 per cent of the liable funds (plus the addition to these which is permitted by law) and of the deposits.	The total of the debtors plus the bills drawn on debtors shall not exceed 70 per cent of the liable funds (plus the addition to these which is permitted by law) and of the deposits.	The total of the debtors plus the bills drawn on debtors shall not exceed 70 per cent of the liable funds and deposits, the savings deposits being taken at the rate of only 50 per cent.	The total of the debtors plus the bills drawn on debtors shall not exceed 80 per cent of the liable funds and deposits.	No Guiding Ratio established.
III	The liquid resources shall not be less than 20 per cent of the borrowed funds.	The liquid resources shall not be less than 15 per cent of the borrowed funds, the savings deposits being taken at the rate of only 50 per cent.	The liquid resources shall not be less than 15 per cent of the borrowed funds, the savings deposits being taken at the rate of only 50 per cent.	The liquid resources shall not be less than 15 per cent of the borrowed funds, the savings deposits being taken at the rate of only 50 per cent.	The liquid resources shall not be less than 20 per cent of the borrowed funds, the savings deposits being taken at the rate of only 50 per cent.	The liquid resources shall not be less than 20 per cent of the borrowed funds, the savings deposits being taken at the rate of only 50 per cent.	No Guiding Ratio established.
IVa	The total of acceptance credits and bills drawn on debtors shall not exceed three times the liable funds.						
IVb	The acceptance credits and bills drawn on debtors, included in such credits and bills, and not serving directly to finance exports, imports or crops, shall not exceed the liable funds.						

See footnotes on p. 139.

[1] Large banks with branch networks, "State", regional and local banks, and private bankers.

[2] If the position of a commercial bank in regard to Guiding Ratio I is substantially better than the standard laid down, then the Deutsche Bundesbank may take this into account in the application of Guiding Ratio II (Decision of 20/21 June 1951).

REMARKS

Any credit which a credit institution has granted to expelled persons is in principle left out of account in determining whether, and if so, to what extent, the credits granted by the institution are in accordance with the Guiding Ratios, provided that the Lastenausgleichsbank (Bank für Vertriebene und Geschädigte)—(Equalisation of Burdens Bank)—has guaranteed the credit and has placed the funds at the disposal of the credit institution. This applies also to that part of the credit on which the credit institution itself carries the commitment (Decision of 11/12 April 1951).

DEFINITIONS

Liable Funds: These are the liable capital and reserves ("Eigenkapital") within the meaning of Article 11, paras 2 and 3, of the Banking Law (Kreditwesengesetz), plus the global adjustment of values permitted under the tax laws.

Debtors: Credits in current account, and acceptance credits.

Liquid Resources: Cash, balances at Land Central Banks, postal cheque balances, cheques and bills, Treasury bill and non-interest-bearing Treasury bonds of the Federal Government and the Länder, certain foreign Treasury bills and non-interest-bearing Treasury bonds.

Borrowed Funds: Deposits, monies and loans taken, own acceptances and promissory notes in circulation.

The definitions of the Guiding Ratios conform closely with those which are in current use in the banking statistics. There are full explanations indicating which items in the form for the statistical return must be used in the calculation for the purpose of each of the Ratios.

(*b*) *Money-Market Regulation and Money-Market Policy*

The open-market operations of the Bank deutscher Länder were conducted until 1955 within narrow limits. They were mainly confined to offsetting short-term money-market fluctuations. In order to be able to conduct open-market policy on a broader basis in accordance with the objects of credit and liquidity policy, the Bank in the years 1955 to 1957 concluded with the Federal Minister of Finance special agreements under which it could obtain, in exchange for a corresponding part of its Equalisation Claim, Federal Treasury Bills or non-interest-bearing Federal Treasury Bonds having between six months and two years to run. These administrative agreements have now been replaced by the provisions of Article 42 of the Law concerning the Deutsche Bundesbank. According to these the Federal Government, as the debtor in respect of the Equalisation Claim which the Deutsche Bundesbank holds under the Monetary Reform provisions, is on the Bank's request to hand to it Treasury Bills or non-interest-bearing Treasury Bonds in denominations and on terms of the Bank's choice ("mobilisation paper") up to a maximum of DM 4 billion. On the Bank's request the Cabinet may increase the maximum to the nominal amount of the total Equalisation Claim (see Article 42, paragraph 1, second sentence, of the Law concerning the Deutsche Bundesbank). In September 1957 the maximum was increased, on request, to DM 7 billion.

The mobilisation paper is payable at the Bundesbank. The Bank is under obligation to the Federal Government to meet all liabilities arising from such mobilisation paper.

In the course of its regulation of the money market the Bundesbank furthermore arranges the placing of Treasury Bills and non-interest-bearing Treasury Bonds which are issued by the Federal Government, its Special Funds and the Länder, as well as of Promissory Notes of the Import and Storage Agencies (Storage Agency Bills).

The Bundesbank lays down the selling rates for the money-market paper mentioned, and also the purchasing rates so far as such paper is purchased (Decision of 11 January 1956).

(*c*) *Provisions as to Minimum Reserves*

After entry into force of the Bundesbank Law, except for one single provision, the instructions as to minimum reserves issued by the various Land Central Banks to credit institutions under Article 14, paragraph 2, second sentence, of the Land Central Bank Law in accordance with the specimen instruction [6] approved by the Board of Directors of the Bank deutscher Länder for the time being remained in force and to that extent mutatis mutandis continued to be valid (Announcement of the Deutsche Bundesbank dated 1 August 1957). The exception was the deletion of Article 2, paragraph 1 (b), of the Instructions as to Minimum Reserves (Notice No. 2004/57). The said paragraph provided for liabilities arising from the taking of earmarked monies, so far as the latter had not yet been passed on, to carry the reserve obligation even though they had periods to maturity of four years or more and/or were liabilities towards credit institu-

[6] See the Report of the Bank deutscher Länder for the Year 1956, page 121 and following pages.

tions subject to the reserve obligation. Cancellation of this special arrangement followed from Article 16, paragraph 1, first sentence, of the Bundesbank Law, under which liabilities in respect of long-term borrowings and liabilities towards credit institutions required to maintain minimum reserves cannot be subjected to the minimum-reserve obligation.

On 1 May 1955 the Instructions as to Minimum Reserves previously issued by the Land Central Banks to the credit institutions were abolished. They were replaced by the Deutsche Bundesbank's Order on Minimum Reserves of 28 March 1958, adopted by the Central Bank Council under Articles 6 and 16 of the Bundesbank law.

The principal innovation contained in the Bundesbank's Order is the cancellation of the earlier provision—issued in accordance with Article 14, paragraph 2, first sentence, of the former Land Central Bank Law—stipulating that the credit institutions with branch establishments in several Land Central Bank areas had to decentralise their maintenance of reserves. The institutions operating on a supra-regional basis are now able, therefore, to distribute the minimum reserves at will among the Land Central Banks in whose area the Bundesbank's account-keeping branch establishments appropriate for their branches are located (Article 5, paragraph 1).

A further material change against the previous arrangement is the provision that liabilities in respect of foreign-currency deposits are no longer exempt from the reserve obligation generally, but only to the extent to which they have against them balances with foreign banks after deduction of those balances which are kept abroad as cover for customers' balances covering letters of credit and other covering balances (Article 2, paragraph 3 (c) and (d)). The previous arrangement (Decision of 8 July 1953) was based on the assumption that the credit institutions, if only for reasons of liquidity, would provide corresponding cover for the foreign-currency deposits by maintaining balances with foreign banks. Experience has shown however that this was by no means always the case. For reasons of liquidity and monetary policy it was therefore thought advisable to exempt foreign-currency deposits from the minimum-reserve obligation only in so far as the requisite covering balances are actually kept with foreign banks. It is not necessary however for the covering balances to be expressed in the same currency as the customers' deposits.

Another point of major importance is the limitation of the exceptional arrangement for "earmarked monies passed on" by a narrower definition of the term "earmarked monies" (Article 2, paragraph 3 (b)). The new wording makes it clear that the exceptional ruling does not apply to liabilities in respect of deposits. Liabilities in respect of earmarked monies taken come under the exceptional ruling, i. a., only if both the monies and the corresponding lendings run for not less than one year.

Apart from that the former provisions remained on the whole unchanged in substance.

The rate of the special interest charged for failure to meet the reserve requirement had previously been established in the Instructions as to Minimum Reserves. Under the new Order, on the other hand, it is specified from time to time by the Bundesbank. With effect from 1 May 1958 the special interest under Article 10, paragraph 1, of the

Bundesbank's Order on Minimum Reserves was fixed at three per cent above the Deutsche Bundesbank's advance rate applying on the 15th of the month in question (Decision of 24 April 1958). This has not altered the situation in any way.

With effect from 1 September 1957 the reserve ratios in respect of liabilities towards nonresidents and subject to the reserve obligation were raised to 30 per cent in the case of sight liabilities and to 20 per cent in the case of time liabilities (Decision of 8 August 1957).

The following is the text of the Order on Minimum Reserves in force since 1 May 1958.

THE DEUTSCHE BUNDESBANK'S ORDER ON MINIMUM RESERVES OF 28 MARCH 1958

In pursuance of Articles 6 and 16 of the Law concerning the Deutsche Bundesbank the Central Bank Council of the Deutsche Bundesbank has made the following Order as to Minimum Reserves:

I. General Provisions

ARTICLE 1

(1) Credit institutions within the meaning of this Order comprise all enterprises conducting bank or savings-bank business within the country (Article 1 of the Banking Law).

(2) Not subject to the reserve obligation are—

(a) the enterprises mentioned in Article 2, paragraph 1 d–f, of the Banking Law, even if they conduct bank or savings bank business in addition to the business proper to them;

(b) credit institutions which are in liquidation, and other credit institutions whose activity is confined to winding up.

ARTICLE 2

(1) Liabilities subject to the reserve requirement comprise all liabilities towards—

(a) non-banks,

(b) credit institutions not subject to the reserve requirement, and

(c) banks in foreign countries,

arising from deposits and from loans taken, the latter for agreed periods to maturity, or at agreed periods of notice, of less than four years.

(2) For the purpose of ascertaining the liabilities subject to the reserve requirement an account-holder's deposits payable on demand may be reduced by the offsetting of short-term claims on that account-holder on—

(a) accounts which in the calculation of interest and commission are treated together with the deposit accounts in question as a unit,

(b) special loan accounts in accordance with Article 2, paragraph 4, of the Agreement regarding Debtor Interest (the so-called "English accounting method").

This does not apply to deposits in foreign currency.

(3) Exempt from the reserve requirement are liabilities—

(a) towards the Bundesbank;

(b) in respect of earmarked monies taken as loans running for not less than one year, so far as the said monies have already been passed on to the recipients or to an intermediary credit institution. Earmarked monies within the meaning of this provision are monies which according to directions laid down from the outset by the lender in regard to the terms of lending in particular are to be lent to borrowers designated by name by the lender or—where it is a case of a public or publicly assisted lending scheme—to borrowers who fulfil the requirements for taking part in the said lending scheme; the life of the loans to be granted must be not less than one year;

(c) of private or public mortgage banks or ship mortgage banks in respect of monies which have been taken as global loans but have not yet been passed on to the borrowers indicated, and for the purpose of securing which there has been transferred to the lender a registered mortgage bond that is covered not by mortgages but by substitute cover through use of the loan monies received;

(d) in respect of balances for covering letters of credit, and of other covering balances, in so far as the credit institution for its part maintains a covering balance in respect of them at a bank within the country or abroad;

(e) in respect of foreign-currency deposits to the extent of the credit balances held at banks abroad; of the said credit balances, for this purpose, that part will be left out of account which has already been reckoned in accordance with (d);

(f) in respect of customers' drawings on credits opened at other credit institutions;

(g) in respect of the receipt of amounts collected purely on a commission basis, so far as the said amounts are currently paid over to the beneficiaries. This also applies to liabilities of the security-clearing institutions known as "Kassenvereine" in respect of redemption monies paid to them. Amounts are to be regarded as "currently paid over" if they remain at the collecting institution for not longer than 14 days;

(h) in respect of compensation balances within the meaning of Article 4 of the Law on Currency Conversion Compensation for Expelled Persons' Savings Balances, in so far as such balances have not yet been released (Article 11, paragraph 3, of the Law);

(i) in respect of savings deposits to the extent of the Covering Claims held under the "Old Savers' Law" for amounts credited as compensation on deposit accounts.

ARTICLE 3

(1) Among the liabilities subject to the reserve requirement a distinction is made between:

(a) sight liabilities,

(b) time liabilities, and

(c) savings deposits.

(2) Sight liabilities are deemed to comprise liabilities due on demand, as well as liabilities in respect of which a period of notice of less than one month or a period to maturity of less than 30 days has been agreed, and liabilities in respect of customers' balances for covering letters of credit and of their other covering balances.

(3) Time liabilities are deemed to comprise

(a) liabilities in respect of which a fixed period to maturity of at least 30 days has been agreed;

(b) liabilities in respect of which a period of notice of at least one month has been agreed.

(4) Savings deposits are deemed to comprise deposits within the meaning of Chapter VII (Article 22 and following Articles) of the Banking Law.

ARTICLE 4

A "bank place" (Bankplatz) within the meaning of the provisions as to minimum reserves is any place at which the Deutsche Bundesbank maintains a branch. In exceptional cases where due reason exists the appropriate Land Central Bank may declare localities within a "bank place" which are difficult of access, for example distant suburbs included within the municipal boundaries, to be "non-bank places".

II. Reserve Obligation

ARTICLE 5

(1) Credit institutions subject to the reserve requirement (Article 1) are required to maintain minimum reserves at the Bundesbank as credit balances on giro account.

(2) Agricultural credit cooperatives which are members of a regional central institution and maintain no giro account at the Bundesbank are to keep the minimum reserves as balances payable on demand on a special account at their central institution; to the extent of the balances on such accounts the central institution is to maintain credit balances at the Bundesbank.

ARTICLE 6

The duty to maintain minimum reserves is fulfilled if a credit institution's actual reserve (Article 9) comes up to the required reserve (Article 7).

III. Calculation of the Required and Actual Reserve

ARTICLE 7

(1) The required reserve is found by applying the percentages specified by the Bundesbank (reserve ratios) to the monthly average, ascertained in accordance with Article 8, of the liabilities subject to the reserve requirement (Article 2). In the case of credit institutions with more than one branch or office the monthly averages of the individual branches' or offices' liabilities subject to the reserve requirement will be reckoned together.

(2) The required reserve of a central institution of agricultural credit cooperatives means the required reserve found according to paragraph 1 plus the total actual reserves of the cooperatives holding reserves with it.

(3) If the reserve ratios are set at different levels according to the size of the institutions (reserve categories) then the ranking of a credit institution in one of the reserve categories is determined by the total of the monthly averages shown in the previous month's Reserve Statement (Article 11) for its sight and time liabilities subject to the reserve requirement.

ARTICLE 8

(1) The monthly average of the liabilities subject to the reserve requirement will be calculated from the totals at the close of the business and non-business days in the period from the 24th of the previous month to the 23rd of the current month.

(2) The monthly average can instead be calculated from the total of the liabilities subject to the reserve requirement as they stand at the close of the following four days:

Last day of the previous month;
7th day of the current month;
15th day of the current month;
23rd day of the current month.

(3) Agricultural credit cooperatives may use, in place of the monthly average, the total of the liabilities subject to the reserve requirement as they stood at the close of the last day of the previous month. In exceptional cases where due reason exists the appropriate Land Central Bank may permit other credit institutions to do the same.

(4) If one of the days mentioned in paragraphs 1 to 3 falls on a non-business day, then for the total of the liabilities subject to the reserve requirement on that day the total at the close of the previous business day shall be taken.

(5) In the case of agricultural credit cooperatives which maintain minimum reserves in accordance with Article 5, paragraph 2, the appropriate Land Central Bank may permit an ascertained monthly average to stand good for a further period of up to five months.

(6) The monthly average is to be ascertained according to the same procedure for all the categories of liabilities subject to the reserve requirement (Article 3).

ARTICLE 9

(1) The actual reserve means the monthly average of the credit balance maintained in accordance with Article 5. It will be calculated from the totals at the close of all the days in the month, the total balance on any non-business day being deemed to be the balance ascertained as at the close of the preceding business day, and will be notified to the credit institution at the close of the month by the Bundesbank (Central Cash Office).

(2) If a credit institution keeps a giro account at more than one office of the Bundesbank, the actual reserve is deemed to be the total of the monthly averages of the individual credit balances.

IV. Special Interest

Article 10

(1) If in any month a credit institution's actual reserve falls short of its required reserve the said credit institution shall for 30 days pay on the deficiency, unless the Bundesbank grants a request for waiver of the interest payment, special interest at the rate from time to time ordered by the Bundesbank.

(2) Deficiences of agricultural credit cooperatives which maintain minimum reserves in accordance with Article 5, paragraph 2, may not be offset by the central institution against its own surplus reserve or the surplus reserve of another cooperative. In respect of deficiencies of cooperatives the central institution shall pay the special interest to the Bundesbank.

V. Reserve Statement

Article 11

(1) Not later than the 5th business day in each month every credit institution subject to the reserve requirement is in respect of the past month, except as otherwise provided in paragraphs 2 and 3, to submit a Reserve Statement (Form 1500, Section A) to the account-keeping office of the Bundesbank. For each day (Article 8) this Statement shall show—on a schedule in the case of institutions which calculate in accordance with Article 8, paragraph 1 the monthly average of the liabilities subject to the reserve requirement—the liabilities subject to such requirement divided according to the different categories (Article 3) and, divided between liabilities in accordance with paragraphs 2 and 3 of Article 2, the liabilities left out of account in accordance with said paragraphs of that Article.

(2) In the case of credit institutions having more than one office or branch each such office or branch is to render a Reserve Statement (Form 1500, Section A). The head office is in addition to render a Combined Statement (Form 1500, Section B), in which the monthly averages of each branch's or office's liabilities subject to the reserve requirement and of its Bundesbank giro balances are to be separately shown, so far as the branch or office maintains a Bundesbank giro account of its own; the monthly averages of the liabilities, subject to the reserve requirement, of branches or offices not having a Bundesbank giro account of their own may be shown in summary with an indication of the number of such branches or offices. The monthly averages of the liabilities subject to the reserve requirement are in every case to be split between bank places and non-bank places according to Form 1500 (Section B). The head office is to submit the Combined Statement together with the Statements of the individual branches or offices, also not later than the 5th business day in the month, to the Bundebank's accounkeeping office appropriate to its location; the appropriate Land Central Bank may permit their submission to another office of the Bundesbank.

(3) Agricultural credit cooperatives which maintain minimum reserves in accordance with Article 5, paragraph 2 are to give to their central institution the data required in Form 1500 (Section A) for the calculation of the required reserve. For each cooperative maintaining a reserve with it the central institution shall state, in a schedule to its Reserve Statement, the monthly averages (Article 8) of the liabilities subject to the reserve requirement, the required reserve and the actural reserve.

(4) The Bundesbank may cause the ascertainment of the liabilities subject to the reserve requirement to be explained to it in the Reserve Statement or in a schedule thereto. It retains the right to assure itself that the said ascertainment is in order.

VI. Coming Into Force

Article 12

This Order comes into force on 1 May 1958. At the same time the instructions given by the Land Central Banks to credit institutions as to minimum reserves cease to have effect.

Deutsche Bundesbank
(sgd.) Blessing
(sgd.) Dr. Wolf

(*d*) *Credit Limits of the Public Authorities*

In accordance with Article 20, paragraph 1, of the Law concerning the Deutsche Bundesbank the Bank may grant short-term credits in the form of book and Treasury Bill credits (known as cash advances) to the following public administrations:

to the Federal Government up to DM 3,000 million;
to the Federal Railways up to DM 400 million;
to the Federal Postal Administration up to DM 200 million;
to the Equalisation of Burdens Fund up to DM 300 million;
to the E.R.P. Special Fund up to DM 59 million;

to the Länder up to DM 20 per inhabitant according to the last official census; in the case of the Land of Berlin and the Free and Hanseatic Cities of Bremen and Hamburg an amount of DM 40 per inhabitant serves as the basis of computation.

Treasury Bills which are issued by these public administrations and which the Bundesbank has purchased for its own account, or in respect to which it has given an assurance of purchase, are counted against the credit limits. This however does not apply to Federal Treasury Bills which have been handed to the Bank in pursance of Article 42, paragraph 1, of the Law concerning the Deutsche Bundesbank (Mobilisation Treasury Bills).

In addition the Bank may grant credits to the Federal Government with a view to fulfilment of the latter's obligations as members of the following institutions:

(a) the International Monetary Fund up to DM 1,500 million;
(b) the European Fund up to DM 180 million;
(c) the International Bank for Reconstruction and Development up to DM 35 million.

Credits have so far been granted to the Federal Government against these limits to the extent of DM 483.2 million, of which payments to the International Monetary Fund account for DM 452.9 million, while financing of the subscription paid in dollars to the International Bank for Reconstruction and Development accounts for DM 30.3 million.

INTEREST RATES AND MINIMUM RESERVE RATIOS OF THE DEUTSCHE BUNDESBANK*

(a) Rates for Discounts and Advances, and Special Rate of Interest charged for failure to meet the Minimum Reserve Requirement

Applicable as from—	Discounts,[1] % per annum	Advances on securities, % per annum	Special rate of interest charged to credit institutions for failure to meet minimum reserve requirement, % p. a. over advance rate
1948—July 1	5	6	1
Dec. 1			3
1949—May 27	4½	5½	
July 14	4	5	
1950—Oct. 27	[2] [3] 6	7	
Nov. 1			1
1951—Jan. 1			3
1952—May 29	[4] 5	6	
Aug. 21	4½	5½	
1953—Jan. 8	4	5	
June 11	3½	4½	
1954—May 20	3	4	
1955—Aug. 4	3½	4½	
1956—Mar. 8	4½	5½	
May 19	[5] 5½	6½	
Sep. 6	5	6	
1957—Jan. 11	4½	5½	
Sep. 19	4	5	
1958—Jan. 17	3½	4½	

*Up to 31 July 1957 rates of Bank deutscher Länder and of Land Central Banks.

[1] This is also the rate for cash advances to public authoritiesand to the Reconstruction Loan Corporation; cf. footnotes 3 and 4. The discount rate for bills expressed in foreign currency was uniformly fixed at 3%, for the time being, by a decision adopted by the Board of Directors of the Bank deutscher Länder on 3 August 1948. By decision of 9/10 November 1949 the Board of Directors authorised the Board of Managers to fix varying rates for bills in this class, in accordance with the discount rates of the foreign Central Banks. The same applies to bills in DM which have been accepted abroad (Decision of 22/23 March 1950), and also to export drafts (Decisions of 15/16 November 1950 and 23/24 May 1951); cf. footnote 5.

[2] Promissory notes arising under the export promotion scheme of the Reconstruction Loan Corporation were discounted at the preferential rate of 4% even after the raising of the discount rate on 27 October 1950 (Decision of 29/30 November 1950). This privilege in regard to the interest rate was cancelled by decision of 7/8 November 1951; and it could then be claimed only for promissory notes arising from credits which were granted or promised not later than 7 November 1951.

[3] Under a decision taken by the Board of Directors of the Bank deutscher Länder on 20 December 1950 the interest rate for cash advances to the Reconstruction Loan Corporation was fixed, with effect from 27 October 1950, at 4% in the case of lendings to agriculture, maritime shipping and housebuilding, while for credits serving other purposes it was fixed at 5½%.

[4] Since 29 May 1952 there has been in effect only the special arrangement mentioned under 3 for lendings to be used for financing agriculture, maritime shipping and housebuilding, to which lendings the rate of 4% continues to apply.

[5] As from 19 May 1956 also discount rate for foreign bills, foreign cheques, foreigners' DM acceptances and export drafts.

b) Minimum Reserve Ratios [*]

Applicable as from:	For credit institutions																						For Land Central Banks [2]
	Liabilities towards residents																			Liabilities towards non-residents			
	Sight deposits												Time deposits						Savings deposits	Sight deposits	Time deposits	Savings deposits	
	at "Bank places" [x]						at other places																
	Reserve category [1]												Reserve category [1]										
	1	2	3	4	5	6	1	2	3	4	5	6	1	2	3	4	5	6					
	in per cent of the liabilities subject to the reserve requirement																						
1948 July 1	10						10						5						5	up to 30 April 1957 the same rates were applying as to liabilities towards Residents			20
Dec. 1	15						10						5						5				
1949 June 1	12						9						5						5				
Sep. 1	10						8						4						4				12
1950 Oct. 1	15						12						8						4				
1952 May 1	15	14	13	12	11	10	12	11	10	9	8	8	8	7.5	7	6.5	6	5.5	4				
Sep. 1	12	12	11	11	10	9	10	10	9	9	8	8	7	7	6	6	5	5	4				
1953 Feb. 1	11	11	10	10	9	9	9	9	8	8	8	8	7	7	6	6	5	5	4				
1955 Sep. 1	12	12	11	11	10	10	10	10	9	9	9	9	8	8	7	7	6	6	5				
1957 May 1	13	13	12	12	11	11	11	11	10	10	9	9	9	9	8	8	7	7	6	20	10	10	
Sep. 1	13	13	12	12	11	11	11	11	10	10	9	9	9	9	8	8	7	7	6	30	20	10	

[*]) Applying to the credit institutions in the area of the Federal Republic and, as from 1 May 1954, also to the credit institutions in Berlin (West). Prior to 1 May 1954, partly different regulations applied to the West-Berlin credit institutions. — [x]) "Bank places" are places at which there is a branch establishment of the Deutsche Bundesbank.

[1]) Since 1 May 1952 the credit institutions have been graded as follows, the amounts representing the totals of their liabilities (other than savings deposits) subject to the reserve requirement:

	Millions of DM		Millions of DM
Reserve category 1	100 and over	Reserve category 4	from 5 to under 10
" " 2	from 50 to under 100	" " 5	" 1 " " 5
" " 3	" 10 " " 50	" " 6	under 1

The reserve class into which any credit institution is to be placed is determined by the amount of its sight and time liabilities subject to the reserve requirement in the previous month.

[2]) No longer applicable since entry into force of the Law concerning the Deutsche Bundesbank (1 August 1957).

LAW CONCERNING THE DEUTSCHE BUNDESBANK OF 26 JULY 1957*

The Bundestag has adopted the following Law:

SECTION ONE—ESTABLISHMENT, LEGAL FORM AND FUNCTIONS

ARTICLE 1—ESTABLISHMENT OF THE DEUTSCHE BUNDESBANK

The Land Central Banks and the Berlin Central Bank shall be merged with the Bank deutscher Länder. The Bank deutscher Länder shall become the Deutsche Bundesbank.

ARTICLE 2—LEGAL FORM, ORIGINAL CAPITAL AND SEAT

The Deutsche Bundesbank shall be an autonomous Federal institution and a legal person under public law. Its original capital of two hundred and ninety million Deutsche Marks shall be the property of the Federation. The Bank shall have its seat at the seat of the Federal Government; so long as this is not in Berlin, the seat of the Bank shall be in Frankfurt am Main.

ARTICLE 3—FUNCTIONS

The Deutsche Bundesbank, making use of the powers in the field of monetary policy conferred upon it under this Law, shall regulate the note and coin circulation and the supply of credit to the economy with the aim of safeguarding the currency and shall ensure the due execution by banks of payments within the country as well as to and from foreign countries.

ARTICLE 4—PARTICIPATIONS

The Deutsche Bundesbank shall be authorised to participate in the Bank for International Settlements and, subject to the approval of the Federal Government, in other institutions serving the purposes of a supra-national currency policy or facilitating international payments and credit transactions or otherwise useful to the Bundesbank in discharging its functions.

SECTION TWO—ORGANISATION

ARTICLE 5—ORGANS OF THE DEUTSCHE BUNDESBANK

The organs of the Deutsche Bundesbank shall be the Central Bank Council ("Zentralbankrat") (Article 6), the Directorate ("Direktorium") (Article 7), and the Boards of Management ("Vorstände") of the Land Central Banks (Article 8).

ARTICLE 6—THE CENTRAL BANK COUNCIL

(1) The Central Bank Council shall determine the monetary and credit policies of the Bank. It shall lay down general directives for the conduct of business and administration and shall delimit the responsibilities of the Directorate and of the Boards of Management of the Land Central Banks in accordance with the provisions of this Law. The Council may also, in individual cases, issue instructions to the Directorate and to the Boards of Management of the Land Central Banks.

(2) The Central Bank Council shall consist of the President and the Vice-President of the Deutsche Bundesbank, the other members of the Directorate, and the Presidents of the Land Central Banks.

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* Appendix 7 to the Report of the Deutsche Bundesbank for the Year 1957.
Translation of the German text as contained in the Federal Law Gazette, Part 1 1957 No. 33, of 30 July 1957, page 745 et seq.

(3) The Central Bank Council shall meet under the chairmanship of the President or the Vice-President of the Deutsche Bundesbank. It shall take its decisions by a simple majority of the votes cast. The By-laws shall lay down any other conditions governing the taking of decisions. The By-laws may provide that members of the Central Bank Council who are prevented from attending meetings for a prolonged period shall be represented by deputies.

ARTICLE 7—THE DIRECTORATE

(1) The Directorate shall be responsible for the implementation of the decisions taken by the Central Bank Council. It shall manage and administer the Bank, except in matters coming within the competence of the Boards of Management of the Land Central Banks. More particularly, the following business shall be reserved to the Directorate:

1. Transactions with the Federation and its Special Funds;
2. Transactions with credit institutions which have central functions for the whole of the Federal territory;
3. Foreign exchange transactions and transactions with foreign countries;
4. Open market transactions.

(2) The Directorate shall consist of the President and the Vice-President of the Deutsche Bundesbank and of not more than eight further members. The members of the Directorate must possess special professional qualifications.

(3) The President and the Vice-President as well as the other members of the Directorate shall be appointed by the President of the Federal Republic on the proposal of the Federal Government. The Federal Government shall consult the Central Bank Council before making its proposals. The members shall be appointed for eight years, or in exceptional cases for a shorter period, but not less than two years. All appointments and retirements shall be published in the Federal Advertiser ("Bundesanzeiger").

(4) The members of the Directorate shall hold office under public law. Their status in relation to the Bank, in particular regarding salaries, pensions, and surviving dependents' allowances, shall be regulated by contracts concluded with the Central Bank Council. Such contracts shall be subject to the approval of the Federal Government.

(5) The Directorate shall meet under the chairmanship of the President or the Vice-President of the Deutsche Bundesbank. It shall take its decisions by a simple majority of the votes cast. In the event of a tie, the chairman shall have the casting vote. The By-laws shall lay down any other conditions governing the taking of decisions. The By-laws may provide that specific decisions require a unanimous vote or some other majority of votes.

ARTICLE 8—LAND CENTRAL BANKS

(1) The Deutsche Bundesbank shall maintain a Main Office in each Land. The Main Offices shall be designed as the "Landeszentralbank in Baden-Württemberg, in Bayern, in Berlin, in Bremen, in der Freien und Hansestadt Hamburg, in Hessen, in Niedersachsen, in Nordrhein-Westfalen, in Rheinland-Pfalz, in Schleswig-Holstein", respectively.

(2) The Board of Management of each Land Central Bank shall conduct all transactions and administrative business within the area for which the Main Office concerned is competent. More particularly, the following business shall be reserved to the Land Central Banks:

1. Transactions with the Land and with public administrations in the Land;
2. Transactions with credit institutions within their area of competence, except such transactions as are reserved to the Directorate under Article 7 paragraph (1) item 2.

(3) The Board of Management of each Land Central Bank shall consist of the President and the Vice-President. The By-laws may permit the appointment of one or two additional members of the Board of Management and may lay down regulations governing the taking of decisions by Boards of Management. The members of the Boards of Management must possess special professional qualifications.

(4) The Presidents of the Land Central Banks shall be appointed by the President of the Federal Republic on the proposal of the Bundesrat. The Bundesrat shall make its proposals on the basis of a recommendation of the authority competent under Land legislation, and after consulting the Central Bank Council.

The Vice-Presidents and the other members of the Boards of Management shall be appointed by the President of the Deutsche Bundesbank on the proposal of the Central Bank Council. The members of the Boards of Management shall be appointed for eight years, or in exceptional cases for a shorter period, but not less than two years. All appointments and retirements shall be published in the Federal Advertiser.

(5) The members of the Board of Management shall hold office under public law. Their status in relation to the Bank, in particular regarding salaries, pensions and surviving dependents' allowances, shall be regulated by contracts concluded with the Central Bank Council. Such contracts shall be subject to the approval of the Federal Government.

ARTICLE 9—ADVISORY BOARDS AT THE LAND CENTRAL BANKS

(1) At each Land Central Bank there shall be an Advisory Board which shall consult with the President of the Land Central Bank on questions of monetary and credit policies, and with the Board of Management of the Land Central Bank on the execution of the tasks incumbent on the latter within its area.

(2) The Advisory Board shall consist of not more than ten members who should be specially conversant with credit matters. Not more than half of the members should be chosen from the various branches of the credit business, and the other members from industry, commerce and agriculture and from among wage-earners and salaried employees.

(3) The members of the Advisory Board shall be appointed for a period of three years by the President of the Deutsche Bundesbank on the proposal of the respective Land Government and after consulting the Board of Management of the Land Central Bank concerned.

(4) The President of the Land Central Bank or his deputy shall act as chairman at meetings of the Advisory Board. The appropriate Land Ministers shall be afforded the opportunity of attending meetings of the Advisory Board. They may require a meeting of the Advisory Board to be convened. In all other respects the proceedings of the Advisory Board shall be regulated by the By-laws.

ARTICLE 10—BRANCH ESTABLISHMENTS

The Deutsche Bundesbank shall be authorized to maintain branch establishments (Main Branches and Branches). Each Main Branch shall be directed by two managers who shall be responsible to the appropriate Land Central Bank. Each Branch shall be directed by one manager who shall be responsible to the appropriate Main Branch.

ARTICLE 11—REPRESENTATION

(1) The Deutsche Bundesbank shall be represented in and out of court by the Directorate; in the area of competence of a Land Central Bank, it shall also be represented by the latter's Board of Management, and within the area of a Main Branch, also by the managers thereof. Article 31 paragraph (2) and Article 41 paragraph (4) shall not be affected hereby.

(2) Declarations of intent shall commit the Deutsche Bundesbank if made by two members of the Directorate or of the Board of Management of a Land Central Bank or by two managers of a Main Branch. Such declarations may also be made by authorised representatives appointed by the Directorate or, in the area of competence of a Land Central Bank, by the latter's Board of Management. A declaration of intent to be made to the Bank shall be legally effective if made to any one person authorised to represent the Bank.

(3) Authority to represent the Bank may be proved by a certification signed by a notarial official of the Deutsche Bundesbank.

(4) Actions against the Deutsche Bundesbank, which relate to the business of a Land Central Bank or of a Main Branch, may also be brought at the Court having jurisdiction in respect of the seat of the Land Central Bank or the Main Branch concerned.

SECTION THREE—FEDERAL GOVERNMENT AND BUNDESBANK

ARTICLE 12—THE BANK'S RELATIONSHIP TO THE FEDERAL GOVERNMENT

The Deutsche Bundesbank shall be bound, in so far as is consistent with its functions, to support the general economic policy of the Federal Government.

In the exercise of the powers conferred on it under this Law it shall be independent of instructions of the Federal Government.

ARTICLE 13—CO-OPERATION

(1) The Deutsche Bundesbank shall advise the Federal Government on matters of primary importance in the field of monetary policy and shall upon request furnish information to the Federal Government.

(2) The members of the Federal Government shall be entitled to take part in the deliberations of the Central Bank Council. They shall have no vote, but may bring motions. At their request the taking of a decision shall be deferred, but for not more than two weeks.

(3) The Federal Government will invite the President of the Deutsche Bundesbank to participate in its deliberations on matters of importance in the field of monetary policy.

SECTION FOUR—POWERS IN THE FIELD OF MONETARY POLICY

ARTICLE 14—NOTE ISSUE

(1) The Deutsche Bundesbank shall have the exclusive right to issue bank notes in the area to which this Law applies. Its notes shall be expressed in Deutsche Marks. They shall be the sole unrestricted legal tender. Notes for amounts of less than ten Deutsche Marks may only be issued in agreement with the Federal Government. The Deutsche Bundesbank shall give public notice of the denominations and distinguishing characteristics of the notes which it issues.

(2) The Deutsche Bundesbank may call in notes for withdrawal. Notes called in shall cease to be legal tender upon expiry of the period for exchange fixed in the notice of call.

(3) The Deutsche Bundesbank shall not be under any obligation to replace notes destroyed, lost, forged or falsified, or having ceased to be legal tender. The Bank shall replace mutilated notes if the holder either presents fragments of a note which taken together are larger than half the note or submits proof that the remainder of the note of which he presents only one half or a smaller portion has been destroyed.

ARTICLE 15—DISCOUNT, CREDIT, AND OPEN MARKET POLICIES

For the purpose of influencing the circulation of money and the supply of credit, the Deutsche Bundesbank shall from time to time fix the interest and discount rates to be applied to its transactions and shall determine the principles governing its credit and open market operations.

ARTICLE 16—MINIMUM RESERVE POLICY

(1) For the purpose of influencing the circulation of money and the supply of credit, the Deutsche Bundesbank may require the credit institutions to maintain with it, on giro account, balances (minimum reserve) equal to a specified percentage of their liabilities arising from sight, time and savings deposits and from short and medium-term borrowings, with the exception of liabilities to other credit institutions required to maintain minimum reserves. The rates fixed by the Bank shall not exceed thirty per cent for sight liabilities, twenty per cent for time liabilities, and ten per cent for savings deposits. Within these limits the Bank may fix the rates at various levels in accordance with general principles, in particular for individual groups of institutions, and may exclude certain liabilities from the computation.

(2) The average monthly balance of a credit institution with the Deutsche Bundesbank (actual reserve) must not be less than the percentages, fixed in accordance with paragraph (1), of the monthly average of that institution's liabilities subject to the reserve requirement (required reserve). The Bank shall issue detailed regulations concerning the computation and establishment of the actual reserve and of the required reserve.

(3) On the amount by which the actual reserve falls short of the required reserve the Deutsche Bundesbank may charge a special interest rate of up to three per cent above the current rate for advances against securities. The special interest rate will not be charged where the short-falling was due to unforeseeable circumstances and thus unavoidable, or where the credit institution concerned has gone into liquidation. The Deutsche Bundesbank shall

report any substantial or repeated short-falling to the Bank Supervisory Authority.

(4) Agricultural credit co-operatives which are members of a regional central institution and maintain no giro account with the Deutsche Bundesbank may keep their minimum reserves with their central institution; the latter shall maintain balances in an equal amount at the Deutsche Bundesbank.

(5) The minimum reserves to be maintained under this Law shall be counted towards the liquidity reserves to be maintained under other laws.

ARTICLE 17—DIRECTIVE GOVERNING DEPOSITS

The Federation, the Equalisation of Burdens Fund, the E. R. P. Special Fund and the Länder shall deposit their liquid funds, including cash resources earmarked for special purposes in the budget, with the Deutsche Bundesbank on giro account. Deposit or investment in any other manner shall require the approval of the Bundesbank which shall, however, give due consideration to the interest which the Länder have in maintaining their State and Land Banks.

ARTICLE 18—STATISTICS

For the purpose of discharging its functions, the Deutsche Bundesbank shall be authorised to instruct all credit institutions to prepare statistics on banking and monetary matters for collection by the Bundesbank. Articles 7, 10 and 12 paragraph (1) of the Law on Statistics for Federal Purposes shall be applicable as appropriate. The Deutsche Bundesbank may publish the results of the statistics for general purposes. Such publications must not contain any individual data. Persons entitled under Article 13 paragraph (1) to receive information may be given individual data only if and in so far as this is provided for in the instructions regarding statistics.

SECTION FIVE—SPHERE OF OPERATIONS

ARTICLE 19—TRANSACTIONS WITH CREDIT INSTITUTIONS

(1) The Deutsche Bundesbank may engage in the following transactions with credit institutions in the area to which this Law applies:

1. Purchase and sell bills of exchange and cheques backed by three parties known to be solvent; the third signature may be dispensed with if the security of the bill or cheque is guaranteed in some other way; the bills must be payable within three months from the date of purchase; they should be good commercial bills;
2. Purchase and sell Treasury bills issued by the Federation, by one of the Federal Special Funds specified in Article 20 paragraph (1) item 1 or by a Land, and payable within three months from the date of purchase;
3. Grant interest-bearing loans against collateral (advances on securities) for a period not exceeding three months; such loans may be granted against—
   (a) bills of exchange meeting the requirements stated in item 1, up to a maximum of nine-tenths of their nominal value,
   (b) Treasury bills meeting the requirements stated in item 2, up to a maximum of nine-tenths of their nominal value,
   (c) non-interest-bearing Treasury bonds maturing within one year from the date of the loans, up to a maximum of three-quarters of their nominal value,
   (d) fixed-interest-bearing bonds and claims on the Debt Register (Schuldbuchforderungen) issued or payable by the Federation, by any of the Federal Special Funds or by a Land, up to a maximum of three-quarters of their quoted value,
   (e) other fixed-interest-bearing bonds and claims on the Debt Register specified by the Bank, up to a maximum of three-quarters of their quoted value,
   (f) equalisation claims (Ausgleichsforderungen) entered in the Debt Register in accordance with Article 1 of the Law on the Redemption of Equalisation Claims, up to a maximum of three-quarters of their nominal value.
   If there is no stock exchange quotation for any one of the securities referred to under (d) and (e), the Bank shall value that security according to the possibilities of realisation. In the event of default of a debtor under an advance on securities, the Bank shall be authorised to put the pledge up to auction through one of its own officials or through an official authorised

to hold auctions, or, if the object pledged has a stock exchange or market price, to sell it at the current price through one of these officials or through a broker and to reimburse itself out of the proceeds for costs, interest and principal; the Bank shall retain this right even against other creditors and against the estate of a debtor in bankruptcy;

4. Accept non-interest-bearing giro deposits;

5. Accept objects of value, in particular securities, for safe custody and administration; the Bank may not exercise any voting rights attaching to the securities held in safe custody or administered by it;

6. Receive cheques, bills of exchange, payment orders, securities and interest coupons for collection, and after collection effect payment of the proceeds, unless the Bank should rule otherwise regarding the crediting of the proceeds in the case of cheques and payment orders;

7. Transact other banking operations in accordance with instructions received, subject to cover being provided;

8. Purchase and sell media of payment expressed in foreign currency, including bills of exchange and cheques, claims and securities, as well as gold, silver and platinum;

9. Transact any banking business with foreign countries.

(2) As regards the transactions specified in paragraph (1) items 1 to 3, the Bundesbank shall apply its discount rates and its rates for advances on securities.

ARTICLE 20—TRANSACTIONS WITH PUBLIC ADMINISTRATIONS

(1) The Deutsche Bundesbank may engage in the following transactions with public administrations:

1. Grant short-term credits in the form of book and Treasury bill credits (cash advances) to the Federation, to the Federal Special Funds as listed below, and to the Länder. The maximum limit of the cash advances including such Treasury bills as the Deutsche Bundesbank has purchased for its own account or to the purchase of which it has committed itself shall amount—

(a) in the case of the Federation, to three thousand million Deutsche Marks,

(b) in the case of the Federal Railways, to four hundred million Deutsche Marks,

(c) in the case of the Federal Postal Administration, to two hundred million Deutsche Marks,

(d) in the case of the Equalisation of Burdens Fund, to two hundred million Deutsche Marks,

(e) in the case of the E. R. P. Special Fund, to fifty million Deutsche Marks,

(f) in the case of the Länder, to twenty Deutsche Marks per inhabitant according to the latest official census; for Land Berlin and for the Free and Hanseatic Cities of Bremen and Hamburg, an amount of forty Deutsche Marks per inhabitant shall be used as the basis of computation;

2. Grant credits to the Federation for the meeting of its commitments as a member of the following institutions:

(a) the International Monetary Fund, up to one thousand five hundred million Deutsche Marks,

(b) the European Fund, up to one hundred and eighty million Deutsche Marks.

(c) the International Bank for Reconstruction and Development, up to thirty-five million Deutsche Marks;

3. Effect the transactions described in Article 19 paragraph (1) items 4 to 9 with the Federation, the Federal Special Funds, the Länder and other public administrations; for these transactions the Bank may not charge the public administrations listed in item 1 above any expenses or fees.

(2) The public administrations listed in paragraph (1) item 1 should issue loans, Treasury bonds and Treasury bills preferably through the Deutsche Bundesbank; failing this, such issues shall be effected in consultation with the Deutsche Bundesbank.

ARTICLE 21—OPEN MARKET OPERATIONS

The Deutsche Bundesbank may, for the purpose of regulating the money market, purchase and sell on the open market at market prices:

1. Bills of exchange meeting the requirements of Article 19 paragraph (1) item 1;

2. Treasury bills and Treasury bonds issued by the Federation, by one of the Federal Special Funds as listed in Article 20 paragraph (1) item 1, or by a Land;

3. Bonds and claims on the Debt Register (Schuldbuchforderungen), provided that the debtors are the institutions listed under item 2;

4. Other bonds admitted to official stock exchange dealings.

ARTICLE 22—DEALINGS WITH THE PUBLIC

The Deutsche Bundesbank may effect the transactions specified in Article 19 paragraph (1) items 4 to 9 with both physical and legal persons within the country and abroad.

ARTICLE 23—CERTIFICATION OF CHEQUES

(1) The Deutsche Bundesbank may certify cheques drawn on it only after cover has been provided. By the certification the Bank assumes an obligation to the holder to pay the cheque; it also becomes liable to the drawer and the endorsers for payment.

(2) Payment of a certified cheque may not be refused even if in the meantime bankruptcy proceedings have been instituted against the drawer.

(3) The liability arising out of the certification shall lapse if the cheque is not presented for payment within eight days after issue. As regards proof of presentation Article 40 of the Cheque Law shall apply.

(4) The claim arising out of the certification shall lapse two years after expiry of the period for presentation.

(5) The regulations regarding jurisdiction and procedure in the matter of bills of exchange shall apply mutatis mutandis to the legal enforcement of claims arising out of certification.

ARTICLE 24—LENDING AGAINST AND PURCHASE OF EQUALISATION CLAIMS

(1) Notwithstanding the limitations set out in Article 19 paragraph (1) item 3, the Deutsche Bundesbank may grant loans to credit institutions, insurance companies and building and loan associations against the pledging of equalisation claims within the meaning of Article 1 of the Law on the Redemption of Equalisation Claims, in so far and so long as is necessary for maintaining the solvency of the pledger.

(2) The Deutsche Bundesbank may purchase equalisation claims of the type specified in paragraph (1), subject to the provisions of Article 9 paragraph (1) of the Law on the Redemption of Equalisation Claims, in so far and so long as the resources of the Purchase Fund are not sufficient for this purpose.

ARTICLE 25—OTHER TRANSACTIONS

The Deutsche Bundesbank should effect transactions other than those authorised in Articles 19 to 24 only for the purpose of carrying out and winding up authorised transactions, or for internal operational purposes, or for its staff.

SECTION SIX—ANNUAL STATEMENT, DISTRIBUTION OF PROFITS AND RETURN

ARTICLE 26—ANNUAL STATEMENT

(1) The business year of the Deutsche Bundesbank shall be the calendar year.

(2) The accounting system of the Deutsche Bundesbank shall conform to the principles of regular book-keeping. The provisions of Company Law shall be applicable mutatis mutandis to the valuations in the annual balance sheet.

(3) The Directorate shall prepare the annual statement as early as possible. This statement shall be audited by one or more certified auditors appointed by the Central Bank Council in agreement with the Federal Audit Office. The Central Bank Council shall approve the annual statement, which shall then be published by the Directorate.

(4) The auditor's report shall serve as a basis for the audit to be carried out by the Federal Audit Office. The auditor's report as well as the findings of the Federal Audit Office thereon shall be communicated to the Federal Minister of Economics and the Federal Minister of Finance.

32061—59——11

ARTICLE 27—DISTRIBUTION OF PROFITS

The net profit shall be applied in the following order:

1. Twenty per cent of the profit or twenty million Deusche Marks, whichever is the higher, shall be transferred to a legal reserve until the latter amounts to five per cent of the note circulation; the legal reserve may only be used to offset depreciation and to cover other losses; the fact that other reserves may be available for such purposes shall not preclude the use of the legal reserve;
2. Up to ten per cent of the then remaining part of the net profit may be used to constitute other reserves; the total of these reserves must not exceed the amount of the original capital;
3. Forty million Deutsche Marks, or thirty million Deutsche Marks from the business year 1980 onwards, shall be transferred to the fund constituted under the Law on the Redemption of Equalisation Claims for the purpose of purchasing equalisation claims until that fund is wound up;
4. The remaining balance shall be transferred to the Federation.

ARTICLE 28—RETURN

The Deutsche Bundesbank shall publish a return showing the financial position on the 7th, 15th, 23rd and last day of each month and containing the following particulars:

I. Assets

Gold
Balances at foreign banks and money-market investments abroad
Foreign notes and coin, foreign bills and foreign cheques
Domestic bills of exchange
Advances against securities
Cash advances to—
- (a) the Federation and the Federal Special Funds
- (b) the Länder

Treasury bills and non-interest-bearing Treasury bonds—
- (a) of the Federation and of the Federal Special Funds
- (b) of the Länder

Securities
Divisional coin
Postal cheque account balances
Equalisation claims
Other assets

II. Liabilities

Bank notes in circulation
Deposits of—
1. Credit institutions
2. Public depositors
   - (a) Federation and Federal Special Funds
   - (b) Länder
   - (c) other public depositors
3. Other domestic depositors
4. Foreign depositors

Liabilities in respect to foreign business
Reserves for specific purposes
Original capital
Reserves
Other liabilities

SECTION SEVEN—GENERAL PROVISIONS

ARTICLE 29—SPECIAL STATUS OF THE DEUTSCHE BUNDESBANK

(1) The Central Bank Council and the Directorate of the Deutsche Bundesbank shall have the status of Federal highest authorities. The Land Central Banks and Main Branches shall have the status of Federal authorities.

(2) The Deutsche Bundesbank and its employees shall enjoy the privileges accorded to the Federation and its employees in building, housing and rent matters.

(3) The provisions of the Commercial Code regarding entries in the Trade Register as well as the provisions relating to membership in the Chambers of Industry and Commerce shall not apply to the Deutsche Bundesbank.

ARTICLE 30—NOTARIAL OFFICIALS

The President of the Deutsche Bundesbank may appoint notarial officials for the purposes of Article 11 paragraph (3). They must be qualified to hold the office of judge.

ARTICLE 31—STATUS OF THE OFFICIALS, SALARIED EMPLOYEES AND WAGE-EARNERS OF THE DEUTSCHE BUNDESBANK

(1) The Deutsche Bundesbank shall employ officials, salaried employees and wage-earners.

(2) The President of the Deutsche Bundesbank shall appoint the officials of the Bank, those of the administrative class, however, on the proposal of the Central Bank Council. He may delegate this authority, as regards officials of the executive, clerical and sub-clerical classes, to the Presidents of the Land Central Banks. The President of the Deutsche Bundesbank shall be the supreme service authority and in that capacity shall represent the Bank both in and out of court. He shall impose any disciplinary penalties, except where disciplinary courts are competent, and shall be the authority instituting formal disciplinary proceedings (Article 29 of the Federal Disciplinary Code).

(3) The officials of the Deutsche Bundesbank shall be mediate Federal civil servants. Unless otherwise provided in this Law, the regulations generally applicable to Federal civil servants shall apply to the said officials. The entry into force of this Law shall, in respect to such officials, be substituted for the entry into force of the Federal Civil Service Law.

(4) Subject to the approval of the Federal Government the Central Bank Council shall be authorised to regulate the status of the officials and salaried employees of the Deutsche Bundesbank in Staff Regulations to the extent that is necessary for the orderly and efficient conduct of the Bank's business. The Staff Regulations may only provide that—

1. the following provisions of Federal civil service law be modified in re-
Staff Regulations may only provide that—

(a) Articles 21, 2nd sentence; 24, 3rd sentence; 26, paragraph (1); 30, paragraph (2); 66, paragraph (1) items 2 and 5; 116, paragraph (1) item 3, of the Federal Civil Service Law;

(b) Article 15 of the Salary Law of 16 December 1927 (Reich Law Gazette I, page 349) in the text valid for the Federal Republic, to the extent that the Bundesbank grants revocable, non-pensionable allowances not exceeding thirty per cent of the basic salary, refunds expenditure incurred for official purposes, and pays bonuses for special services;

(c) the provisions relating to the granting of subsistence allowances for civil servants in preparatory service;

2. the officials and salaried employees of the Bank shall be required to notify the Bank of any business or professional activities carried on by their spouses;

3. the salaried employees of the Bank—

(a) shall, in the same manner as the officials of the Bank, require prior approval before they can engage in one of the subsidiary activities specified in Article 66 paragraph (1) items 2 and 5 of the Federal Civil Service Law,

(b) shall receive the emoluments specified in item 1 (b) above.

(5) The bonuses for special services and the refunds of expenditure incurred for official purposes, referred to in paragraph (4) item 1 (b), shall not exceed in the aggregate one twentieth of total expenditure on salaries of officials and salaried employees of the Deutsche Bundesbank.

(6) The Central Bank Council shall, with the approval of the Federal Government, issue regulations relating to qualifying training and careers of the officials of the Deutsche Bundesbank. In so doing it may deviate from the provisions of Federal civil service law requiring the length of the preparatory service and probationary periods and regarding the length of the trial period for promotion within the executive class and for admission to the administrative class.

ARTICLE 32—DUTY OF SECRECY

All persons in the service of the Deutsche Bundesbank shall be pledged to secrecy regarding the affairs, organisation and transactions of the Bank. Even after they have left the service of the Bank they may not, without permission, make depositions or statements in or out of court regarding such of the matters mentioned above as have come to their knowledge during their service with the Bank. Such permission shall, so far as the interests of the Bank are involved, be given to members of the Central Bank Council by that Council and to other employees of the Bank by the President; for purposes of taking evidence in a court of law such permission shall only be withheld when the good of the Federation or the general interest so requires.

ARTICLE 33—PUBLIC ANNOUNCEMENTS

The Deutsche Bundesbank shall publish in the Federal Advertiser its announcements intended for the public, in particular those relating to the calling in of notes, the fixing of interest, discount and minimum reserve rates, as well as instructions regarding statistics.

ARTICLE 34—BY-LAWS

The By-laws of the Deutsche Bundesbank shall be adopted by the Central Bank Council. They shall require the approval of the Federal Government and shall be published in the Federal Advertiser. This shall also apply to amendments of the By-laws.

SECTION EIGHT—PENAL AND OTHER PROVISIONS CONCERNING THE SEIZURE OF FALSE MONEY

ARTICLE 35—UNAUTHORISED UTTERING AND USE OF MONETARY TOKENS

(1) Imprisonment or a fine of unlimited amount, or both, shall be imposed as a penalty on—

1. any person who without authority utters monetary tokens (stamps, coins, notes or other documents that are capable of being used as means of payments instead of the legally authorised coins or bank notes) or non-interest-bearer bonds, even if the value of such tokens or bonds is not expressed in Deutsche Marks;
2. any person who tenders in payment objects of the kind mentioned in item 1 which have been uttered without authority.

(2) The attempts shall be punishable.

(3) If the act described in paragraph (1) item 2 is committed through negligence, a fine shall be imposed.

ARTICLE 36—SEIZURE OF FALSE MONEY AND OF MONETARY TOKENS OR BONDS ISSUED WITHOUT AUTHORITY

(1) The Deutsche Bundesbank and all credit institutions shall seize any counterfeit or falsified bank notes or coins (false money), any bank notes or coins suspected of being false money, as well as any objects of the kind mentioned in Article 35 and issued without authority. A receipt shall be given to the party concerned.

(2) False money and objects of the kind mentioned in Article 35 shall, together with a report, be sent to the police. Credit institutions shall notify any such action to the Deutsche Bundesbank.

(3) Bank notes or coins suspected of being false money shall be submitted to the Deutsche Bundesbank for examination. If the Bundesbank establishes that the bank notes or coins are false, it shall send the false money, together with a report, to the police and shall notify the credit institution that seized it.

ARTICLE 37—CONFISCATION

(1) Objects of the kind mentioned in Article 35 and issued without authority may be confiscated. If it is impossible to prosecute or convict any definite person, confiscation may be ordered independently, provided that all the other relevant conditions exist.

(2) Objects confiscated in accordance with paragraph (1), and false money confiscated by virtue of Article 152 of the Penal Code, shall be held by the Deutsche Bundesbank. They may be destroyed after a period of ten years from the date when the judgment ordering confiscation becomes final if the perpetrator has been discovered, or after a period of twenty years from such date if the perpetrator has not been discovered.

SECTION NINE—TRANSITIONAL AND FINAL PROVISIONS

ARTICLE 38—REORGANISATION OF THE CENTRAL BANKING SYSTEM

(1) The assets of the Land Central Banks and the Berlin Central Bank, together with their liabilities, shall be transferred in their entirety to the Bank deutscher Länder upon the entry into force of this Law. No charge shall be made for the amendment of the Land Register. The Land Central Banks and the Berlin Central Bank shall cease to exist without going into liquidation.

(2) With effect from 1 January 1957 the liabilities of the Länder in respect of equalisation claims held by the Land Central Banks in accordance with the provisions concerning the Monetary Reform shall be transferred to the Federation, and the liability of Land Berlin in respect of the bonds held by the Federation in accordance with Article 23 paragraph (2), 2nd sentence, of the First Law concerning the Transfer of Budgetary Liabilities and Covering Funds to the Federation in the text of 21 August 1951 (Federal Law Gazette I, page 779) shall lapse; in the event of the conversion account of a Land Central Bank being adjusted after the entry into force of this Law, the Federation shall take over all the obligations and rights resulting therefrom. The Bank shall pay fifteen million Deutsche Marks to Land North Rhine-Westphalia and five million Deutsche Marks to Land Berlin, together with six per cent interest thereon as from 1 January 1957, out of the balance of profit due to the Federation in accordance with Article 27 item 4. All claims of the Länder arising from the extinction of their participations in the Land Central Banks and the Berlin Central Bank shall thereupon be regarded as settled.

(3) The Bank shall refund to the Länder the interest paid by them on equalisation claims of the Land Central Banks for the period after 1 January 1957, out of such balance of profit due to the Federation in accordance with Article 27 item 4 as is left after the payments provided for in paragraph (2) have been effected.

(4) The consequences ensuing from Article 2, second sentence, in conjunction with Article 27 shall have effect as from 1 January 1957. The opening balance sheet of the Deutsche Bundesbank shall be drawn up as of that date, with due regard to the provisions of Article 26.

(5) The notes of the Bank deutscher Länder that are valid at the entry into force of this Law shall remain valid as notes of the Deutsche Bundesbank until they are called in by the Directorate. Unissued notes held in stock may be issued as heretofore.

ARTICLE 39—TRANSITIONAL REGULATIONS FOR THE ORGANS OF THE BUNDESBANK

(1) Pending the appointment of the first President of the Deutsche Bundesbank, his duties shall, in so far as they are determined by Articles 6, 8, 9, and 13, be performed by the President of the former Board of Directors of the Bank deutscher Länder, and in all other respects by the President of the former Board of Managers of the Bank deutscher Länder. The President of the Board of Directors of the Bank deutscher Länder and the President of the Board of Managers of the Bank deutscher Länder shall relinquish their offices upon the appointment of the President of the Deutsche Bundesbank without prejudice to their contractual claims.

(2) Pending the appointment of the first Vice-President of the Deutsche Bundesbank, his duties shall be performed by the Vice-President of the Board of Managers of the Bank deutscher Länder. The Vice-President of the Board of Managers of the Bank deutscher Länder shall relinquish his office upon the appointment of the Vice-President of the Deutsche Bundesbank without prejudice to his contractual claims.

(3) The other members of the former Board of Managers of the Bank deutscher Länder shall remain in office as members of the Directorate of the Deutsche Bundesbank until their contracts expire.

(4) The members of the Boards of Managers of the former Land Central Banks shall remain in the office as members of the Boards of Management of the Main Offices of the Deutsche Bundesbank until their contracts expire.

ARTICLE 40—CHANGE IN THE TERMS OF SERVICE

(1) Upon the entry into force of this Law the officials, salaried employees and wage-earners of the Bank deutscher Länder, of the former Land Central Banks and of the Berlin Central Bank shall become officials, salaried employees and

wage-earners of the Deutsche Bundesbank. Officials for life or on probation shall be given the status of civil servants for life or on probation in accordance with the Federal Civil Service Law; officials on revocable appointment shall be given the status of civil servants on revocable appointment in accordance with the Federal Civil Service Law, except where, on satisfying the requirement laid down in Article 5, paragraph (1), item 2, of the Federal Civil Service Law, they are appointed officials on probation; any difference between a higher previous salary and the salary due after the entry into force of this Law shall be compensated by a non-pensionable adjustment allowance payable until compensation has been achieved by salary increases; increases as a result of a change in personal status or of a change in the locality grading, as well as general increases in salaries as result of a change in economic conditions, shall not be taken into account.

(2) In all other respects the provisions of Chapter II, Section III, of the Skeleton Law concerning the Civil Service shall apply. The pension, however, of a temporarily retired official of the Deutsche Bundesbank may not, for a period of five years, be less than fifty per cent of his pensionable salary, calculated on the basis of the final grade in his salary group. This shall not apply to the calculation of surviving dependents' allowances.

(3) Upon the entry into force of this Law officials retired on pension, widows, orphans and other recipients of maintenance from the Bank deutscher Länder, the former Land Central Banks and the Berlin Central Bank shall become recipients of maintenance from the Deutsche Bundesbank. Article 180 of the Federal Civil Service Law shall be applied as appropriate, provided that the entry into force of the present Law shall be substituted for the entry into force of the Federal Civil Service Law. Article 180, paragraph (4), of the Federal Civil Service Law shall apply to former officials of the Bank deutscher Länder, of the former Land Central Banks and of the Berlin Central Bank, and to their surviving dependents.

(4) Paragraph (3) shall apply mutatis mutandis to officials of the Deutsche Reichsbank who after 8 May 1945 were re-employed at an office of the Deutsche Reichsbank in the territory of the Federal Republic in accordance with their former status and have retired without having first been taken into the service of the Bank deutscher Länder, a former Land Central Bank or the Berlin Central Bank, as well as to their surviving dependents.

(5) Claims under the terms of the Federal Laws concerning Indemnification of Public Servants for National Socialist Wrong and concerning Indemnification of Public Servants Living Abroad for National Socialist Wrong, if asserted by persons—

1. who have suffered damage within the sphere of the Deutsche Reichsbank, or
2. who, being members or former members of the Bank deutscher Länder, of the former Land Central Banks or of the Berlin Central Bank, satisfy the conditions laid down in Article 22 paragraph (3) of the Law concerning Indemnification of Public Servants for National Socialist Wrong,

shall be claims against the Deutsche Bundesbank. This shall not apply in cases under item 1 above if another employer is liable for indemnification in accordance with Article 22 paragraph (3) of the aforementioned Law.

(6) As regards persons who have, or could have, received maintenance under the Law to regulate the Status of Persons coming within the Provisions of Article 131 of the Basic Law, Article 41 of the present Law shall be applicable.

(7) Until the entry into force of the provisions of Article 31 paragraphs (4) and (6), or until the expiry of three years after the entry into force of this Law, whichever period is shorter, the regulations issued by the Board of Directors of the Bank deutscher Länder regarding qualifying training and careers of officials, including the rules relating to examinations, as well as Article 1 paragraph (3), 1st sentence, Articles 3, 4, 5, 8, 9 and Article 10 paragraph (2) of the Staff Regulations of the Bank deutscher Länder dated 19 November 1954 (Federal Advertiser No. 231 of 1 December 1954), shall continue to apply; Article 1 paragraph (3), 1st sentence, however, shall apply with the proviso that the President of the Deutsche Bundesbank shall have power of decision only in the cases specified in Article 21, 2nd sentence, and in Article 24, 3rd sentence, of the Federal Civil Service Law.

ARTICLE 41—STATUS OF PERSONS COMING WITHIN THE PROVISIONS OF ARTICLE 131 OF THE BASIC LAW

(1) The Deutsche Bundesbank shall be the "appropriate institution", within the meaning of Article 61 of the Law regulating the Status of Persons coming within the Provisions of Article 131 of the Basic Law in the text of 1 September 1953 (Federal Law Gazette I, page 1287), in relation to the Deutsche Reichsbank, the Nationalbank für Böhmen und Mähren and foreign banks of issue (Item 19 of Annex A to Article 2 paragraph (1) of the aforementioned Law). The Bank shall be exempt from the general obligation to provide employment laid down in Article 11 of the said Law.

(2) Article 62 of the Law referred to in paragraph (1) shall apply mutatis mutandis to officials, salaried employees and wage-earners of the Deutsche Reichsbank who were employed in offices of the Deutsche Reichsbank within the territory of the Federal Republic or of Land Berlin on 8 May 1945, and—

1. who lost their office or employment for reasons not covered by civil service law or by legislation regarding collective agreements and have not yet been given employment again in accordance with their former status, or

2. who bfore the entry into force of the Law referred to in paragraph (1) have completed their sixty-fifth year of life or have become incapable of work and who, for reasons not covered by civil service law or by legislation regarding collective agreements, receive no pension, or no appropriate pension.

(3) The assessment basis for retired officials of the Deutsche Reichsbank who retired before 1 September 1953 (Article 5 paragraph (1) item 1, Article 6 paragraph (2), Article 35 paragraph (1) and Article 48 of the Law referred to in paragraph (1)) shall continue to be the same as laid down in the German Civil Service Law valid in the Federal Republic (pensionable salaries, pension rates), subject to the modifications resulting from Articles 7 and 8, Article 29 paragraphs (2) and (3) and Article 35 paragraph (3) of the Law referred to in paragraph (1), as well as from Article 110 and Article 156 paragraph (1) of the Federal Civil Service Law. The pension shall not exceed seventy-five per cent of the pensionable salary. The same shall apply mutatis mutandis to surviving dependents. Article 129 of the Federal Civil Service Law shall apply if the maintenance claim has arisen after 1 July 1937.

(4) The President of the Deutsche Bundesbank shall be the supreme service authority for persons to whom the provisions of paragraphs (1) and (2) are applicable. In this respect he shall represent the Bank both in and out of court. Where in cases under paragraph (1) the concurrence of the Federal Minister of Finance is specified in the Law therein referred to and in the civil service legislation to be applied in accordance therewith, he shall act in lieu of the Minister.

ARTICLE 42—MOBILIZATION OF THE EQUALIZATION CLAIM FOR OPEN MARKET OPERATIONS

(1) The Federation, as the debtor in respect of the equalisation claim which the Deutsche Bundesbank holds in accordance with the provisions concerning the Monetary Reform, shall hand over to the Bank, upon the latter's request, Treasury bills or non-interest-bearing Treasury bonds in denominations and on terms of the Bank's choice ("mobilisation paper") up to a maximum of four thousand million Deutsche Marks. On the request of the Bank, the Federal Government may increase the maximum to the nominal amount of the total equalisation claim.

(2) Such mobilisation paper shall be payable at the Deutsche Bundesbank. The Bank shall be under an obligation to the Federation to meet all liabilities arising from such mobilisation paper. The Federation shall continue to pay the interest on the entire equalisation claim.

(3) The Federal Minister of Finance shall be empowered to issue such mobilisation paper up to the maximum amount permissible under paragraph (1). Mobilisation paper shall not be counted towards the credit ceiling referred to in Article 20 paragraph (1) item 1 (a).

ARTICLE 43—REPEAL AND AMENDMENT OF LEGAL PROVISIONS

(1) The following legal provisions shall be repealed:

1. the Law on the Establishment of a Bank deutscher Länder, with the exception of paragraph 15 (c) thereof,

2. the Law concerning the Land Central Banks,

3. the Issue Law,

4. Article 11 paragraph (3) and Article 24 paragraph (4) of the Conversion Law.

(2) The following legal provisions shall be amended:

1. Article 11 paragraph (3) of Regulation No. 2 under the Conversion Law and Article 11 paragraph (4) of Regulation No. 23 under the Conversion Law shall read as follows:

"The sale of an equalisation claim before its entry in the Debt Register shall not be permissible."

2. Article 3 paragraph (4) of Regulation No. 33 under the Conversion Law shall read as follows:

"(4) Article 11 paragraph (4) of the Conversion Law and Article 11 of Regulation No. 2 under the Conversion Law shall be applicable mutatis mutandis to equalisation claims; financial institutions, insurance companies and building and loan asociations may, under the same conditions, purchase equalisation claims or accept them as security for loans."

3. Article 35 paragraph (3) of the Supplementary Conversion Law of 21 September 1953 (Federal Law Gazette I, page 1439) shall read as follows:

"(3) Article 11 paragraph (4) of the Conversion Law and Article II paragraph (3) of Regulation No. 2 under the Conversion Law shall be applicable to equalisation claims."

4. In Article 7 paragraph (1) item 5 of the Law on the Reconstruction Loan Corporation in the text of 22 January 1952 (Federal Law Gazette I, page 65) the words "by the Board of Directors of the Bank deutscher Länder" shall be replaced by the words "by the Federal Government".

ARTICLE 44—LIQUIDATION

The Deutsche Bundesbank can only be liquidated by law. The liquidation law shall make provision for the disposal of the assets.

ARTICLE 45—BERLIN CLAUSE

In accordance with the provisions of Article 13 paragraph (1) of the Third Law on the Transfer of Financial Powers of 4 January 1952 (Federal Law Gazette I, page 1), the present Law shall also apply to Land Berlin. In applying this Law the Deutsche Bundesbank shall take into consideration the economic situation of Berlin, if necessary by means of special regulations.

ARTICLE 46—SAAR CLAUSE

This Law shall not apply in the Saarland.

ARTICLE 47—ENTRY INTO FORCE

(1) This Law shall enter into force on the first day of the month following its promulgation; Article 40 paragraph (5) and Article 41 paragraphs (1) and (2) shall, however, be effective as from 1 April 1951.

(2) In Land Berlin, Article 41 paragraphs (1) and (2) shall enter into force with effect from 1 October 1951, and Articles 35 and 37 not until the day following the publication, in the Gazette of Laws and Ordinances for Berlin, of the Law extending the validity of this Law to Berlin.

The constitutional rights of the Bundesrat have been observed.

The above Law is herewith promulgated.

Bonn, 26 July 1957.

THEODOR HEUSS
The President of the Federal Republic
ADENAUER
The Federal Chancellor
LUDWIG ERHARD
The Federal Minister of Economics
SCHÄFFER
The Federal Minister of Finance

ITALY

CENTRAL BANKING IN ITALY*

1. Historical Setting

Among European central banks, the central bank of Italy, the Banca d'Italia (Bank of Italy), is a comparative newcomer, having been founded in 1893 as a result of a financial crisis. It originated as a private stock company through the merger of three large commercial banks but was not brought into close connection with the government until the reforms of 1926 and 1936. In 1926 the Bank of Italy received the sole right of note issue, and in 1936 it was reformed into "the bank of banks," deprived of the right of discounting bills directly for private customers, and changed from a limited liability company into an institution of "public right." The central bank now is the "head" of the complicated Italian banking system, with branches in every province; it supervises the commercial banks, including the issuance of short-term credit, and it acts as the bank of the Government of Italy.

2. Ownership and Control of the Central Banking Institution

Since 1936, the capital of the Bank of Italy, amounting to 300 million lira, has been held by savings banks (the majority stockholder), public law banks, banks of national interest, provident institutions, and insurance companies. The powers of the stockholders, however, are quite limited, and do not go beyond approval of the balance sheet and election of the auditors. After being approved by the Government (in practice the Ministry of the Treasury), the governor, general manager, and vice manager are appointed by the Superior Council, which is composed of the governor and the twelve elected directors from the Bank's twelve main branches; a treasury representative sits with the council.

The profits of the central bank go to the Treasury after payment of a dividend to the stockholders of 6 per cent and after transfer of 40 percent into reserves.

3. Relationship of the Central Bank to the Government

Although subject to the treasury supervision—the treasury official on the Superior Council can suspend any action pending its approval by the Minister of the Treasury—the central bank is not a subservient institution. The Governor of the Bank, by virtue of his membership of the Interministerial Committee for Credit and Savings—the government body which decides monetary and credit policy—and prob-

*Prepared at the request of the Joint Economic Committee by the Division of International Finance, Board of Governors of the Federal Reserve System, Washington, D. C.

ably in part because of the high caliber of the men who have had the governorship, is able to exert great influence on these policies. The rapid expansion of the Italian economy under conditions of price stability and balance of payments equilibrium since 1948 has in large part been due to the government's "defense of the lira" policy, which has been strongly promoted by the Governor of the Bank of Italy.

From time to time, the Bank has been under legal obligation to make advances to the Treasury, but late in 1947, when the "defense of the lira" policy went into effect, the outstanding amount of advances was frozen; and since that time the treasury indebtedness to the Bank has been reduced and held at about one-sixth that amount. The Bank of Italy has no legal obligation to purchase treasury paper, but it is obligated by law to make advances to the government up to a limit of 15 per cent of budget expenditure. This ceiling is high, and it could be abused; but the Treasury has in practice kept its indebtedness to the Bank far below the legal limit.

The central bank finances the foreign exchange office (the Governor of the Bank of Italy is chairman of the board of directors of the foreign exchange office) by means of advances, and it in effect administers the foreign exchange market in accordance with market requirements and monetary policy.

4. Relation of the Central Bank to Commercial Banks

The Bank of Italy has wide discretionary power to intervene directly and indirectly in the management and administration of banks. It is permitted to deal with financial institutions other than banks of deposit. For example, certain specialized agricultural banks, which give ordinary and development credit to the agrarian sectors of the economy and which normally do not accept deposits, have special rediscount facilities at the Bank. These agricultural banks rediscount so-called "pool finance bills," which are the bills arising from the financing of certain crops and products supported by the Government.

Although the Bank is prohibited from discounting bills directly for private customers, it can make advances to them on the collateral of government and related securities. Normally the Bank's rate on advances is no greater than the yield on the collateral; customers are therefore able to convert their treasury bonds into cash with little or no loss. The commercial banks, which can discount bills at the Bank of Italy, prefer to take advances from the central bank rather than rediscount, because the Bank can discriminate between bills tendered for rediscount, while it cannot do this with government securities offered as collateral for advances.

5. Power of the Central Bank Over the Instruments of Monetary Policy

Neither discount rate changes nor changes in reserve requirements has played an important role in monetary policy in Italy. Also, the money market as we know it in the United States exists in only an embryonic stage; open market operations by the central bank thus do not enter significantly into Italian monetary policy. The Bank relies primarily upon moral suasion and its right to refuse to rediscount or make advances to the commercial banks and financial institutions. Its controls over large bank loans, capital issues, and medium- and long-term credit by the specialized financial institutions are also important instruments of monetary policy.

6. Channels or Sources Supplying Business Capital

The Bank of Italy does not directly finance business, but it can make advances on, or rediscount bills offered by banks and by the many official and semiofficial agencies which supply credit to business. The institution principally responsible for financing small business is the Istituto Centrale per il Credito a Medio Termine (Mediocredito), which acts as a bankers' bank by rediscounting bills discounted by the regional medium-term banks, and by guaranteeing loans granted by these banks to medium and small enterprises. Export financing has become an important part of its business recently. A similar institution, the Cassa per il Credito ale Imprese Artigiane, provides short- and medium-term credit to artisans. Neither of these institutions is permitted to receive deposits.

STRUCTURE OF THE ITALIAN CREDIT SYSTEM*

I. INTRODUCTION

This summary is intended to give a brief picture of the types of lending institutes existing in Italy, the scope of their activities and the controls to which they are subject.

II. SHORT-TERM VERSUS MEDIUM- AND LONG-TERM OPERATIONS

Banking Act of 1936 introduced into the credit system a rigid classification of the different types of lending institutions, with each type governed by specific provisions. The major feature of this classification was the sharp distinction drawn between institutions holding deposits payable on demand or at short notice, and those deriving their funds from medium- and long-term savings.

In the first group fell the banks proper. Their authority to engage in medium- and long-term credit operations was very sharply curtailed and, in the case of the three banks of "national interest," such operations were forbidden. Even in the cases where the longer-term credit activities were sanctioned, in recognition of their historical and statutory roles in the credit field, there was generally emphasized the concept of correlating the nature of the operation with the source of funds.

In the second group were the financial institutes permitted to exercise medium- and long-term credit to industry and for public works, the institutes of real-estate credit and housing credit, and the institutes of agrarian credit.

III. TYPES OF COMMERCIAL BANKS

The banks themselves were further subdivided into groups on the basis of their historical function, their ownership and the size of the geographical area in which they might operate.

1. The six banks of public law

In a category apart are the four ancient banks, the Banco di Napoli, the Banco di Sicilia, the Instituto di S. Paolo di Torino, and the Monte dei Paschi di Siena, which are given statutory recognition as "banks of public law" because of their functioning historically as quasi-public bodies. These four banks have no share capital, their capital assets consisting of funds accumulated through the centuries or as the result of donations and contributions. At present they are non-profit institutions, with all profits realized either being retained by the banks or utilized for works of general welfare and public utility. Also declared a bank of public law is the more recently es-

*Prepared by the Office of the Treasury Attaché, American Embassy, Rome.

tablished Banca Nazionale del Lavoro, over 98 percent of whose stock is held by the Ministry of the Treasury. Dividends of not more than 6 percent may be paid out, with remaining profits destined for augmentation of capital and reserves and general welfare projects. The Banca di Sardegna which was established in 1944, is also considered a bank of public law. The activities of these six are subject to greater Government control than are those of other banks in that their statutes must be approved by Decree of the Ministry of the Treasury, their presidents and directors are nominated by the Minister, and a Government official is represented on each of their Councils.

While these banks function as normal commercial banks, they have attached to them autonomous departments dealing in long-term credit (see below), which have from time to time acted as agents for the Treasury and, conversely, have enjoyed certain benefits and privileges.

In addition to the investment credit activities of the credit departments, the four older banks, the Banca Nazionale del Lavoro and the Banca di Sardegna may themselves engage in long-term credit operations on behalf of public bodies up to a limit of 30 percent of their deposits, and up to a quota of their net worth, varying from 5 to 10 percent, for operations to other persons.

Like the three banks of "national interest" below, the banks of public law may be authorized to operate throughout the country.

2. Banks of national interest

There are three of these banks, the Banca Commerciale Italiana, the Credito Italiano and the Banco di Roma, who by fulfilling the requirement of having branches in at least 30 of the provinces have been designated by Presidential Decree as "banks of national interest." As such, all their shares must be registered; and only Italian nationals are permitted voting rights. They are subject to more than ordinary Government control through Government representation on their Councils and the requirement that their statutes must be approved by Decree of the Minister of the Treasury. Aside from the five above, they are the only commercial banks that may receive permission to operate on a nation-wide basis.

While legally constituted as private joint-stock companies, the majority of their stock is now held by IRI, a state-controlled corporation discussed later.

3. Ordinary commercial banks

These are the banks engaging in the normal banking operations (including, by law, some medium and long-term operations which are however kept in practice to a very low level by the banking supervisory agency). Their activities are generally either regional or interregional, seldom extending beyond three or four regions. Excluding the 210 popular banks mentioned below, there are at present 209 of these banks.

4. Popular banks

Originally developed to meet the short-term credit requirements of the cooperative members, primarily of modest means, the 210 popular banks are now distinguished from the other ordinary commercial banks mainly by their cooperative form of ownership and the large number of small share-holdings, inasmuch as they have been gradually extending their activities to non-members. Although a few are large and operate interregionally, the bulk are generally small and serve the smaller localities.

5. Savings banks

Old banks, somewhat akin to the five banks of public law in their historical functions, the savings banks originated as non-profit institutions for stimulating savings among low-income groups. Now 80 in number, they are presently engaging at a provincial and, in a few cases, at an international level in all forms of banking activity, and are functioning as normal commercial banks. The juridical nature of the savings banks is public; they have endowment funds instead of share capital. In view of this characteristic and of their tradition of investment in government securities, the savings banks have been excluded from the compulsory reserve which other banks must keep with the Bank of Italy. The feature distinguishing them from the other commercial banks—a carry-over from the needs that gave rise to their establishment during the first half of the nineteenth century—are the small size of their individual deposits, collected mostly from the agricultural classes, their higher-than-normal investment in Government bonds, their financing of the agricultural market in great measure, and in the continued exercise of medium and long-term credit financing, which, however, may not exceed 35 percent of the capital administered. In practice, loans and discounts that are mortgage-secured are limited to 15 percent, while the other operations (e. g., loans not mortgage-secured, purchase of payment certificates issued by the national or local governments, and the purchase of shares in institutes or agencies) are kept within 20 percent. Among the savings banks there are some which are quite large and one, the Cassa di Risparmio delle Provincie Lombarde, is actually one of the biggest banking concerns in Italy.

6. Other types of banks

Operating within the communes and subject to special laws governing their management and liquidation are the 705 rural and artisan banks, an outgrowth of the old rural limited partnership and cooperatives. Limited originally to farmers the membership was extended to include artisans in 1937.

Also considered as commercial banks and subject to the banking regulations are certain of the pawnbroker banks, which, while continuing with money lending in the old sense, also act as credit agents in the money market. These banks are subject to, or exempt from, the banking laws, depending on the volume of the deposits they accept.

7. Foreign banks

Under existing law, foreign banks may not operate branches in Italy, unless they are incorporated in Italy. As such, the Italian subsidiary becomes subject to the same provisions as other Italian commercial banks.

IV. The Central Bank

At the head of the banking system, expressly empowered by law as the supervisory organ over the commercial banks and the exercise of short-term credit, is the Bank of Italy, which also serves as the Government's banker.

While established in 1893, through a merger of several banks, as a privately owned joint-stock company, the Bank of Italy had at its beginnings some characteristics of a public organ. Sharing with the Bank of Naples and the Bank of Sicily the right of note issue, it was already subject to certain Government controls. Its public character was further developed under the banking laws of 1926 which gave it exclusive rights of banknote issue and of managing clearing houses, as well as a certain measure of direct supervisory control over other banks. By special arrangement, it also became banker for the Government. When, during the depression of 1929, it became necessary for the Bank of Italy to assist some of the large banks and industrial firms, it was subjected to further Government controls which crystallized in 1936 when the Bank was declared an institution of public law.

Under the new regulations, the right of subscribing to its 300 million lire of capital was limited to the banks of public law, the banks of national interest, the savings banks and insurance institutes. The Governor, Director General and Deputy Director General must be approved by the Government (in practice, the Ministry of the Treasury), with final approval by the Head of State. Further Government controls are exercised through the participation on the Bank's Superior Council of a Treasury official who has power of suspending any action, pending the final confirmation or reversal by the Minister of the Treasury. In addition, the books and the accounting of funds are under regular review by the Ministry of the Treasury. Annual profits must be distributed 20 percent to reserves, another 20 percent to extraordinary reserves, 6 percent to the shareholders, with the remaining 54 percent going to the Government.

There is at least one Bank of Italy branch in each province.

Under the present legal authorizations, the powers of the Central Bank in the money and financial market are practically unlimited. Among its functions are the exclusive right to issue notes (except those in denominations of 10, 50 and 100 lire and under, which are issued by the State), and with it the control of currency circulation. It is repository of the legal reserves required since 1947 of the commercial banks. Using its nationwide tributary branches, it serves as the Government collection and disbursing agent. It rediscounts paper for other banks. It finances the foreign trade of the country, rediscounting bills of exchange, and buying and selling gold and foreign currencies. It also finances the operations of the Italian Exchange Office, the administrative organ regulating all foreign transactions, and thus the Bank of Italy actually administers foreign exchange according to the market's requirements and Italian monetary policy. It is a source of financing Treasury operations, subject to only limited Parliamentary restrictions. And, as described in greater detail below, it has wide discretionary powers to intervene directly as well as indirectly in the management and administration of the banks themselves. In addition, while the Bank is forbidden to discount commercial and industrial paper directly, it may accept time and demand deposits from banks and nonprofit organizations and advance short-term credit guaranteed by government bonds.

The Bank of Italy finances Treasury operations in several ways. While outright advances are at present limited by law to 443 billion lire, the Bank may and does authorize overdrafts on the Treasury's current account up to a limit now set by law of 15 percent of the Government's total estimated operating expenditures for the current fiscal year. The Bank can also buy, without statutory limitation, Treasury bills with maturity of four months or less. Another source of financing that is presently significant is the rediscounting of payment certificates arising from Government operations in the collection and sale of food products, mostly wheat. Used in lieu of cash for payment to farmers, the certificates are discounted at the banks and other financial institutions and later rediscounted by the Bank of Italy. They are redeemed upon sale of the product. While the Bank is further empowered to discount and rediscount Treasury bills and to invest in Government and Government-guaranteed securities, the volume of such transactions is rather small.

V. Controls in the Banking System

1. General legislative controls

Prior to 1926, supervision of the credit field had been confined to those quasi-public institutions which had been established under special charters in answer to specific social and economic needs, such as the savings banks and the rural and agrarian banks already mentioned, and the institutes dealing in real-estate, housing and agrarian credit, to be discussed later. With the activities of the other credit institutes unregulated, there had been in the early 20's an enormous expansion in the number of banks and in bank activity. The banks, filling the gap left by the absence of financial institutes equipped to supply the needs of the long-term capital market, were moreover investing heavily, and, frequently, speculatively, in long-term industrial loans.

Enacted in an attempt to curb and control some of these activities, the legislation of September and November 1926 constituted the first step toward systematizing and regulating the ordinary banking activity. The new controls proved inadequate, however, in stemming the overexpansion of the banking activities. After the 1929 crisis and the remedial actions taken to salvage the banks in the early 1930's, there were instituted with the legislation of March 1936 overall comprehensive controls under the tenet that "the collection of savings and all credit transactions are matters in the public domain." Although some modifications and amplifications have been introduced since, the present system of controls is essentially that inaugurated or confirmed in the 1936 legislation.

For the most part, the prevailing legislative controls take the form of delegating wide discretionary powers to supervisory bodies, rather than the specification of detailed regulations. Thus, the Interministerial Committee for Credit and Savings (composed of the Minister of the Treasury, chairman, and the Ministers of Public Works, Industry and Commerce, Agriculture and Forestry, Foreign Trade, and State Holdings, with the Governor of the Bank of Italy participating at the meetings) has been delegated the authority of determining general credit policy. To the Bank of Italy is entrusted the implementation of the Committee's policies relating to commercial banks; and to the Ministry of the Treasury, those relating to the financial institutions. In addition, the existing legislation stipulates certain specific requirements that must be met by the commercial banks, as well as the nature of the controls that their supervisory organs may exercise. On the other hand, the legislative references to the financial institutes are more general, tending merely to confirm the general supervisory powers of the Treasury that had already been bestowed upon it in the individual laws establishing the institutions.

2. Regulation and control of the commercial banks

In compliance with statutory regulations or through the wide powers given the Interministerial Committee and the Bank of Italy, the controls over the activities of the commercial banks cover practically all phases of their activity including the authority to intervene in the administration and management of individual banks.

All banks must be registered with, and submit periodic financial statements and minutes of meetings to, the Bank of Italy which may also make site inspections. New banks and branches may be opened only upon the authorization of the Bank of Italy which also determines the minimum capital requirements for the opening of a new bank. Mergers must be cleared with the Bank of Italy.

As already indicated in the section describing the various categories of banks, clear restrictions on the scope of operations have been prescribed. Some of these apply to all banks and some only to specific categories of banks. The restrictions include the following: the definition of territorial jurisdiction; the types of credit operations that can be effected; the preferential position given the banks of public law, the savings banks and the first-class pawnbroker banks in regard to the granting of loans to public bodies; the restrictions on investments in stocks and real estate; and the forbidding of holdings of shares in other banks and of interbank deposits, except for reciprocal service accounts. The size of unsecured loans to individual borrowers is in general limited to one-fifth of the bank's capital and reserves, except upon special authorization of the Bank of Italy.

The observance of the cartel arrangements on interest rates and banking charges, instituted by some of the larger banks to protect themselves from the intense competition prevailing after World War I and adopted later by the Banking Association, has also been made compulsory for all banks by the formal sanction of the Interministerial Committee. Since February 1954 the banking cartel, which had in recent years not been observed, was replaced by an interbank agreement which must be renewed annually.

Of more recent origin is the requirement of reserve deposits, imposed by Decree of the Interministerial Committee in 1947. Promulgated to combat the postwar inflation, the Decree required every commercial bank to set aside as legal reserves an amount equal to one-fifth of the amount of its deposits that was in excess of 10 times its capital and reserves or an amount equal to 15 percent of its total deposits, whichever was smaller. To this amount was to be added two-fifths of any increment in deposits after October 1, 1947, until the reserves reached 25 percent of total current deposits. These reserves are to be either in the form of Government or Government-guaranteed securities deposited with the Bank of Italy, or in blocked

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interest-bearing accounts with the Bank of Italy or the Treasury. By far the major part of these deposits are kept with the Bank of Italy, which may invest them in ordinary Treasury bills according to monetary circulation needs. In this way the Bank of Italy is able to exercise considerable control over the money supply and at the same time furnish financial support to the Treasury. At the end of December 1956, obligatory deposits with the Bank of Italy invested in ordinary bills amounted to 345 billion lire.

Finally, there are the extensive powers given the Bank of Italy in supervising and intervening in the management and operation of the individual banks. Thus, it may order the replacement of a bank's executive body by an extraordinary commission in cases of serious irregularities or heavy or continued losses; and, if warranted, may even revoke the bank's charter. It may call meetings of stockholders or executive boards if deemed in the bank's interest. Moreover, it may regulate such policies as the percentage of profits to be put in reserves and the ratio of investments in real estate or stock to net worth; and may even intervene in the operations to the extent of ordering such measures as the liquidating of investments or the instituting of proceedings against debtors.

VI. Institutes Engaging in Intermediate and Long-Term Credit to Industry and Public Works

The banking law of 1936, in curtailing the longer-term operations of the commercial banks, not only accomplished the separation of long-term from short-term operations but also effectively excluded private enterprises from the field of industrial investment credit. With the exception of some institutions of a private character, the existing institutes authorized to exercise industrial investment credit have all been sponsored by the Government to meet specific situations requiring special assistance. They are either institutes of public law, established by legislative act, with their capital contributed for the most part by the State and the Cassa Depositi e Prestiti, an institute somewhat comparable to the United States Postal Savings system; or alternatively, they are autonomous sections attached to the banks of public law with their operating funds contributed by the State or the Cassa.

Most of the institutes engage in long-term improvement credit as well as the financing of the medium-term capital needs of industry. These longer-term operations differ however from the improvement credit operations discussed in section VII, in that they are carried out for the most part under the same general norms as the longer intermediate operations, while the rules under which the "real-estate" improvement credit is granted are very specifically prescribed by law. The institutes financing public works and public utilities are included in this section together with the industrial credit institutes, since their operations resemble more closely the industrial credit operations.

A. THE INDUSTRIAL CREDIT INSTITUTES

1. Consorzio per sovvenzioni su Valori Industriali

Oldest of the institutes specializing in industrial investment credit is the Consorzio per sovvenzioni su Valori Industriali, roughly translatable as Syndicate for Credit Operations on Industrial Securities. Founded in 1914 as a provisional organization primarily to aid the private stock market, the Consorzio was authorized over the years to expand its activities to include diverse credit operations, unsecured as well as secured by stocks and bonds and commodity collateral, with maximum maturity of five years. It has never exercised the faculty given it of issuing bonds and has for the most part financed its operations by rediscounting with the Bank of Italy. Although active in financing of the Government's military expenditures during the last war, its activities are at present almost entirely confined to the liquidation of old operations. Its stock is owned by the Casa Depositi e Prestiti and a large group of banks and insurance institutes.

2. Istituto Mobiliare Italiano

The Istituto Mobiliare Italiano, or IMI as it is generally called, was established in 1931 to help refinance industry and relieve the banks of their moribund investments. These special assistance functions were taken over by the Istituto per la Ricostrusione Industriale (another Instituto of public law, which has extended widespread aid to both banks and industrial corporations in financial distress, through the purchase of their corporate stock) in 1933. Since then, IMI has become more and more of an institute of industrial credit. Authorized originally to grant loans with maturity up to 10 years on the basis of security collateral, it has seldom exercised this faculty. Instead, it has generally required real and personal guarantees. When its powers were later extended to cover loans with maturity up to 20 years, it extended its operations to cover not only the financing of machinery and equipment purchases but also the granting of improvement credit for plant construction and enlargement. These regular activites of IMI are financed through the issuance of bonds guaranteed by the State.

Since the war, the Government has also charged IMI with the administration of several special credit programs, financed from State funds, such as the financing under especially favorable terms of postwar industrial reconversion and reconstruction and the financing of purchases of machinery and equipment under the MSA/FOA/ICA counterpart program. IMI has also financed operations under loans made to Italy by the United States Export Import Bank.

The capital stock is held predominantly by the Cassa Depositi e Prestiti, with the remainder distributed among a large number of banks and insurance companies.

3. The autonomous industrial credit sections

In 1944 and 1946 respectively, there were established as part of the Government's postwar reconstruction program the autonomous industrial credit sections of the two Southern banks of public law, the Bank of Sicily and the Bank of Naples. Using either the proceeds of bonds issued by the banks proper, which are both Government-guaranteed and interest-subsidized, or funds contributed directly by the State, the sections have engaged in the extension of loans to Southern industry at very favorable terms, with emphasis at first on war-damaged or war-destroyed firms, for financing machinery purchase and plant construction and expansion. More recently, there has been established a comparable section attached to the Bank of Sardinia.

Serving more specialized areas are the autonomous sections for mining credit at the Bank of Sicily and for cinematographic credit at the Banca Nazionale del Lavoro, which also has a section of industrial credit to small and medium business.

4. New medium-term credit organizations

In July 1952 the Government established a new institute, Istituto Centrale per il Credito a Medio Termine a favore delle Medie e Piccole Industrie (Mediocredito) to give an additional impulse towards extending credit in favor of small and medium-sized industries. The juridical nature of Mediocredito is that of a public institute endowed with Government funds. The Mediocredito rediscounts bills or takes over credits or bonds relating to operations connected with the financing of medium and small industries by the special regional institutions and by other industrial lending institutes mentioned elsewhere. In addition, the Mediocredito may also finance medium-term operations connected with exports.

In Southern and Insular Italy, there have recently been created three special medium-term lending institutes: Istituto per lo Sviluppo Economico del'Italia Meridionale (ISVEIMER), Institute Regionale per il Finanziamento alle Industrie in Sicilia (IRFIS) and Credito Industriale Sardo (CIS). Participating in the capital of these public law lending institutes are the large and small banks of each region, the Government through the Cassa per il Mezzogiorno (Fund for the South) and, in the case of Sicily and Sardinia, the two regional Governments. These institutes also administer State funds and international loans channeled through the Cassa per il Mezzogiorno.

The Cassa per il Credito alle Imprese Artigiane (Fund for the Granting of Credit to Handicraft Enterprises) converted by a bill issued in 1952, has the specific object of financing the institutions empowered to grant medium-term credit to handicraft enterprises (namely to all the credit institutions with the exception of the three banks of national interest and the ordinary credit banks). The operations are performed by rediscounting bills or granting credit on security.

5. Other industrial credit institutes

In addition to the quasi-public institutes authorized to grant medium and long-term industrial credit, there exist the *Ente Finanziamenti Industriali* (EFI) established in 1949 with capital contributed by some of the larger industrial firms and banks, which to date has confined its activities to the marketing of industrial obligations, and the Banca Centrale di Credito Mobiliare (Centrobanca), owned by the popular banks, whose activities have also been somewhat limited.

Finally, there is the *Banca di Credito Finanziario*, more generally known as the Mediobanca, established in 1946 with funds contributed by the three banks of national interest which is authorized to transact intermediate credit operations, varying from one to five years.

B. THE CASA DEPOSITI E PRESTITI

Although differing from the other credit institutes, in that it is a part of the Government administration, the Cassa Depositi e Prestiti is an integral part of Italy's credit structure. Now an autonomous department within the Ministry of the Treasury, the Cassa owes its origin to the need for the existence within the Government framework of an organization equipped to receive voluntary deposits as well as those required for certain specified purposes. Most of its funds are derived from the deposits collected through the Postal Savings Banks, and from the services of current accounts and the issuance of postal money orders.

Of its availabilities, a sizeable portion is committed by law to the purchase of State or State-guaranteed bonds. Further financing to the Government is carried out both by means of the interest-bearing current account it holds with the Treasury, in which is deposited the major portion of its receipts from the sale of Postal Savings bonds, and by means of loans to State administrations for the execution of specific public works—generally in cases where the recipient organizations are unable to supply the necessary collateral.

While the Cassa may grant loans directly to private firms, the bulk of its loan operations are either to the State administrations, as described above, or to provincial and communal governments, welfare organizations, agencies carrying out land improvement or other public works, etc. These loans are generally of long maturity, amortizable over 35 years or even 50 years, with part of the interest and even amortization payments subsidized in some cases by the Government.

The Cassa has also contributed heavily to the formation of Government sponsored credit institutes. In addition to its holdings in the Consorzio per Sovvenzioni su Valori Industriali and IMI, it has large holdings in the Consorzio di Credito per le Opere Pubbliche and the Instituto di Credito per le Imprese di Pubblica Utilità.

C. INSTITUTES OF PUBLIC WORKS AND PUBLIC UTILITIES CREDIT

The two institutes specializing in these forms of credit are the two organizations mentioned above, the *Consorzio di Credito per le Opere Pubbliche*, which finances construction of public works, the State-owned public utilities such as the railroads, and land reclamation and improvement, and the *Istituto di Credito per le Imprese di Pubblica Utilità*, which finances the privately-owned public utilities. The Consorzio may grant loans for up to 50 years. Loans by the Instituto to electric and hydro-electric companies, which constitute almost all of its loan operations, are generally granted for 30 years; those to the telephone industry, for 20 years. The financing system employed by these institutes is somewhat similar to that required of the "real-estate" credit institutes under the "credito fondiario" regulations. Granting of loans is counterbalanced by the issue of bonds, backed by the collateral and retirable as the loans are liquidated. In contrast to the "real-estate" credit operations, however, there is a diversity of guarantees that are acceptable as collateral.

VII. The Institutes for Real-Estate, Housing and Tourism Credit

1. General

"Credito Fondiario," roughly translatable as "real-estate" credit, is a specific type of long-term credit that has been narrowly defined by law under the integrative text of 1905 and its subsequent modifications. The principles and rules set forth, which do not limit operations to any specific industrial sector or purpose, were first obligatory only for the institutes dealing in "real-estate" credit in the strict sense. Later, as the needs of individual sectors gave rise to the establishment of specialized institutes for agrarian improvement credit, housing credit, etc., many of the principles and regulations of real-estate credit were carried over into these fields of the special credit.

2. Real-estate credit

The essential characteristics that distinguish "credito fondiario" or "real-estate credit" from the other types of long-term credit are the technical aspects of the financing operation, and the concern with the nature of the security offered rather than with the destination of the loan funds.

Regardless of the purpose of the loan, e. g., whether it is for the improvement of undeveloped property or the purchase of plant equipment, the evaluation of the property put up for collateral is determined by the value of the physical properties without reference to the productive capacities of the borrower. For assessing the value of fixed property destined for industrial use, for example, it is necessary to subtract the expenses that would be incurred in reconverting it to common use.

Loans may be granted only against a first mortgage on real property in an amount that may not exceed one-half of its value, as determined above. In certain special cases, this percentage may be increased to three-quarters. These loans have a maturity ranging from 10 to 50 years, though in practice they rarely exceed 30 years.

Another integral feature of the "real-estate" credit operation is that, concomitant with the disbursement of a loan, the institute issues mortgage certificates with nominal value equal to the amount owed by the borrower, and carrying the same interest rate as the loan. As the loans are repaid, the certificates are redeemed. In actual practice, the borrower frequently receives the loan in the form of mortgage certificates—rather than cash—which he sells at the prevailing market rate. A third characteristic of "real-estate" loans is that the loans are reimbursable in semi-annual equal portion inclusive of interest and accessory costs.

There are 12 institutes, under the direct control of the Ministry of the Treasury, administering "real-estate" credit. Of these, 2 are stock companies, 5 are autonomous sections or separate administrations of the five banks of public law, and the remaining 5 are affiliates or separate administrations of savings banks. In addition to their "real-estate" credit operations, they may also engage in certain collateral operations such as the making of loans secured by mortgage certificates and the investment in mortgage certificates and in public bonds.

3. Low-cost housing credit institutes

In addition to the normal channels for obtaining housing credit through ordinary mortgage or "real-estate" loans, there is available a special form of credit for the construction or purchase of popular, low-cost housing. Only partially subject to the "real-estate" credit regulations, the credit operations are supported by State contributions and other assistance. Loans may be granted up to 75 percent of the value of the land and the contemplated construction, and must be secured by a first mortgage. Payments are made in instalments according to the progress of the works.

Low-cost housing credit may be extended by banks, real-estate credit institutes, housing credit institutes, the public Institute for Social Security, welfare societies, if these are not otherwise prohibited from such operations by law or their statutes. Important in this field is the Instituto Nazionale di Credito Edilizio, a private joint-stock company established in 1925.

Since 1948, there has become available credit under exceptionally favorable terms for the reconstruction of war-damaged or destroyed homes, which is administered by certain selected lending institutes.

4. Hotel credit

The hotel and tourism industry was first given extraordinary financial assistance in the decade of the thirties. In 1937, there was established the Autonomous Section of Hotel Credit at the Banca Nazionale del Lavoro, for the granting of mortgage loans for the construction and improvement of buildings for hotel and tourist use. The loans are administered for the most part under the "real-estate" credit regulations, requiring the "real-estate" credit valuation of collateral and the issuance of bonds similar to the real-estate mortgage certificates. Since 1948, State funds have been made available to the industry, administered by the Autonomous Section and the institutes of real-estate credit.

VIII. Farm Credit

To meet the special needs of the agricultural sector, the basic legislation of 1927 included special provisions for what may be termed "operational" as well as "investment" farm credit. In addition to assistance granted to the lending institutes by means of certain tax-exemption privileges and State contributions to both capital and operating funds agrarian credit has been extended at specially favorable rates of interest and on longer than average amortization terms. Such credits have been based on real-property guarantees in the form of prior liens and mortgages and the end-use control of the financings.

In addition to the normal banking controls exercised over the institutes of agrarian credit as institutes of public law, the Ministry of Agriculture and Forestry also determines annually on the basis of the pending applications and the available resources, the amount of long-term loans that may be granted by the individual lending institutes.

1. Working capital credit

Included in operational credit and loans for financing the purchase of livestock, and of machinery and equipment, with maturity of up to five years; as well as those for financing the production and collateral processing of crops, amortizeable within the crop cycle. Both types of loans are effected by the discount of agricultural paper backed by prior liens on the crop, livestock or machinery, at a rate customarily one-half percent above the rediscount rate of the Bank of Italy. Loans may also be made available against warehouse receipts, with the maturity depending upon the perishability of the crops.

In addition to these forms of credit available to farmers as well as agricultural associations and consortia, the latter may also discount agricultural paper, unsecured by lien, for advancing credit to individual farmers for the processing and collective sale of farm products.

2. Agrarian improvement credit

Available up to 30 years, depending on their purpose, are loans for major improvement works such as construction and repair of farm buildings, land reclamation and re-forestation, irrigation and soil conservation, construction of farm roads, and farm electrification. Loans may be granted up to 60 percent—in exceptional cases, up to 75 percent—of the value of the land and improvement. They are disbursed in installments according to the progress of the work, and are repaid, as in the case of real-estate credit, in equal payments inclusive of interest and accessory costs. While the investment credit loans are generally secured by mortgages and equivalent guarantees, those with maturity of not more than 5 years may be granted through discounting agricultural paper.

3. The institutions extending agrarian credit

There are at present 14 major institutes specializing in the extension of agrarian credit. Three of them, the National Consortium for Agrarian Improvement Credit, the Banca Nazionale del Lavoro and the Banca Nazionale dell'Agricoltura operate on a nationwide scale. The remaining 11 operate within regional or interregional jurisdictions. Generally acting only as intermediaries between the special institutes and the borrowers are also a large group of small communal agrarian institutes, outgrowth of the ancient agrarian banks, that are still prevalent in Southern Italy. In addition, in accordance with the objective of expanding agrarian credit, agricultural credit operations may also be carried on by most kinds of commercial banks as well as by the agrarian consortia and the National Veterans Association.

The 11 regional and interregional institutes are all either affiliates or autonomous sections of commercial banks. Although all but one (which is required to follow the standards of real-estate credit) may extend both operational and improvement credit, their financings are predominantly for working capital. In addition to the operations in their own right and those as local agents for the National Consortium for Improvement Credit, the institutes also serve as supervisory and coordinating bodies with respect to the agricultural loans made by the commercial banks and other lending institutes. While the provisions are not uniform for all eleven institutes, they generally finance their operations through funds supplied by the Government, through rediscount operations with the National Consortium and the Bank of Italy, and through credit extended by their affiliate or other banks.

The National Consortium is the predominant institution in the field of agrarian improvement credit, using for the most part the regional and interregional institutes as local agents. Its capital has been contributed by the State, some of the regional institutes, banks (predominantly the savings banks), and insurance institutes. It has been authorized to issue 15-year interest-bearing bonds up to twice its capital. It may further issue obligations up to 8 times its capital, provided—as in the case of the real-estate mortgage certificates—they are offset by loans guaranteed by mortgage or equivalent collateral.

The Banca Nazionale del Lavoro and the Banca Nazionale dell'Agricoltura, the other two banks of national importance, both confine most of their agricultural financings to working capital credit.

IX. The Italian Bankers Association

The present Italian Bankers Association (ABI), founded in 1945, is the successor of an earlier organization of Italian banks which was founded in 1919. It is a voluntary organization which included all the largest Italian commercial banks as well as a large percentage of savings banks and smaller commercial banks, plus all the special land credit and farming credit institutions in the country.

1. Organization

Ordinary administrative functions are performed by an "Executive Committee" of 14 members, and there is a larger 50-man "Council," including representatives of all the major banks, which deals with matters of special importance. A Chairman and two Deputy Chairmen are appointed for one-year terms, the present Chairman has held office for five consecutive terms.

The ABI's permanent staff consists of three departments:

(*a*) The Technical Banking Department which works on banking regulations, inter-bank agreements, stock exchange matters, and other technical economic problems;

(*b*) The Legal and Fiscal Department;

(*c*) The Research Department.

The ABI has also organized eight advisory Technical Commissions, which consist of technical representatives from member banks and associations. These deal with various economic and financial problems such as rationalization of bank services, exchange control, legal matters, etc., and meet when called upon for advice.

2. Functions

The chief functions of ABI are as follows:

(*a*) It represents the banking sector on a national plane in its relation with the Banca d'Italia, the Italian Government, and other interest groups.

(*b*) It serves as a medium for exchange of views among banking firms.

(*c*) It tries to promote "rationalization of banking services" through its facilities for intercourse among banks.

(*d*) It supplies an advisory service to member banks on technical and fiscal questions.

(*e*) It collects and distributes information on banking and financial matters. In particular it publishes a "Yearbook" containing basic statistics and general information on Italian banks. The ABI also publishes a monthly review entitled "Bancaria," dealing with general financial and economic problems. Its circulation is stated to be the largest of any Italian economic review in its field.

(*f*) It has promoted, since 1954, an interbank agreement on interest charges on loans and deposits and it seeks to foster observance of these charges on the part of the entire banking system.

LONG AND MEDIUM TERM INDUSTRIAL CREDIT IN ITALY*

Before discussing the Italian system as it appears to a Frenchman, it may be useful in a short introduction to summarise present practice concerning long- and medium-term credit in France. There is no question of establishing the superiority of one system or the other. Two countries often have problems that are similar but which appear in rather different shape in the two countries; each country solves its problems in its own way and in the end it often happens that different methods lead to similar results.

More than most problems, the question of long- and short-term industrial credit cannot be isolated from its national context. Each country must find a solution which takes account of local circumstances, or financial methods and of the structure of existing banking facilities.

In France, the practice is to distinguish three categories of credit, according to its duration: short, medium and long term.

Short-term credit (i.e. falling due in less than a year) is available at the commercial banks.

At the other end of the scale, three great public concerns (or mixed public-private concerns), the *Crédit National* (for industry) the *Crédit Foncier* (for construction and building) and the *Crédit Agricole,* grant long-term credit (i.e. for more than five years) using resources obtained by the issue of debentures or by advances from the State. The loans granted by these institutions are subject to the same sort of conditions (documentation, methods of repayment, guarantees, etc.) as are found in other countries, especially in Italy.

Between the two preceding categories comes medium-term credit, running from one to five years, for which a system peculiar

*Banca Nazionale del Lavoro Quarterly Review No. 41, June 1957, pp. 214–232.

to France was devised towards the end of the war, when it was necessary to repair and modernise quickly the equipment of the country before the financial markets had recovered.

When an industrial firm wishes to obtain a medium-term loan it applies to its usual bank which submits a dossier to the *Crédit National*; an ad hoc Committee including a representative of the Bank of France then examines it. If the request is granted a contract is drawn up with at least three signatories (Debtor, Banker, *Crédit National*) and this contract has automatic eligibility at the *Caisse des Dépôts et Consignations* (1) and at the Bank of France. The *Crédit National* gives its signature but does not supply money. The Banker who alone takes the responsibility of the risk of the insolvency of the debtor provides the funds from his resources but he has the power to rediscount the document at any time within the period of the loan (2).

Under this scheme the medium-term loan is thus made by the banks, at their own risk, on the explicit understanding however that their funds will be replenished as need arises, *but with this essential condition that an official body specialising in this business, and the Bank of France itself, acting in advance of the granting of the loan, exercise a strict control on the status of the debtor and the employment of the money.* The Banker, in touch with his client from day to day about short-term loans, does not think it strictly necessary to burden a medium-term credit by guarantees on real property. In fact, the taking of a mortgage, a step rarely taken by a French banker, is confined to *long-term* business.

Inevitably, such an arrangement leads to the inclusion in the portfolio of the Bank of France of a large volume of medium-term credits. But stability was reached during 1954, at least in the financing of industrial equipment, the opening of new credits being covered thereafter by the repayment of old ones.

This summary of French customs is necessarily too simplified and neglects numerous details and many types of application; it will give, however, an overall view sufficient for making intelligible the comparisons which follow.

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(1) The French equivalent of the Italian *Cassa Depositi e Prestiti*.

(2) An analogous system functions with the support of the *Crédit Foncier* which is concerned with loans for building.

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The Italian system of long- and medium-term industrial loans is at first sight extremely complex; understanding will be assisted by a brief reference to its history.

Inspired, in the last century, by methods introduced in France by Péreire and generally followed by German banks, the Italian banks, after massive investments in buildings, railways and iron-works, about 1890 suffered a violent crisis, the liquidation of which required the support of the issuing banks for fifteen years. Due to similar causes another crisis, aggravated by severe deflation, occurred after the first world war. Before the Italian economy could recover from this ordeal the great world depression began.

These events, long and severely felt, gave rise to the bank law of 1936, still in force. This law led to the separation of short-term credit, granted by commercial banks, from long- and medium-term credit which is dispensed by " special institutions " prohibited from the business of taking demand or short-notice deposits. The resources of these special institutions are provided essentially by the issue of debentures and " cash bonds " and by advances from the State.

The State had from the first taken a leading part in the birth and expansion of the special institutions. It had created some in order to free the banks from their frozen commitments and others in order to support public utility works; it established others in order to stimulate enterprise in depressed areas where industrial initiative has recently revived. Apart from two or three joint-stock companies, subsidiaries of banking groups (of which one at least would in France be called " nationalised "), the institutions are in form " public law " institutions, and in fact, at least " mixed " enterprises in the sense either that the State furnished the majority or part of the original capital, or that it grants directly of indirectly, important advances.

The special institutions for industrial credit were developed in four main phases.

1. As early as 1914, the *Consorzio sovvenzioni su valori industriali* (3) was established (it had been planned before the outbreak

(3) More or less a subsidiary of the Bank of Italy which subscribed 43% of the capital, the rest being found by other public institutions.

of war) for granting to banks loans secured by industrial securities and goods; later it was involved in important business for the National Treasury. The *Consorzio* experienced some periods of great activity, notably during the Abyssinian expedition and the second war, obtaining from the Bank of Italy about 40 milliards of rediscounts, equivalent in to-day's values to about 2,500 milliard lire. The *Consorzio* still exists but is dormant.

2. In 1919 and 1924 two institutions were founded in the field most eager for capital at that time:

(i) The *Consorzio di credito per le opere pubbliche* (CREDITOP) which as indicated by its title was intended to provide for public institutions and agencies against annuities guaranteed by the State, and for public services, e.g. railways.

(ii) The *Istituto di credito per le imprese di pubblica utilità* (ICIPU), which from the beginning has been concerned principally with financing electricity and telephones.

3. A third chapter of the history of long-term credit opened in 1931, with the creation of the *Istituto mobiliare italiano* (I.M.I.), whose task was the unfreezing of bank assets frozen by the economic crisis.

The intervention of the I.M.I. soon proved insufficient. In 1933 the Government founded the *Istituto per la ricostruzione industriale* (I.R.I.), which took over from the banks their industrial participations and became the owner of almost all the capital of the three greatest Banks of the time (*Banca Commerciale Italiana, Credito Italiano, Banco di Roma*). Since then the I.R.I. has assumed a double role: that of a holding company whose subsidiaries are industrial undertakings (this is the form taken by Italian nationalisation); and that of an institution lending at long-term for the benefit of certain industries in which it owns some of the capital. Some of these industries have access also to I.M.I. and CREDITOP. Thus the I.R.I.'s financial functions are purely ancillary, and it is usual in Italian statistics to exclude the I.R.I. from the special institutions for long- and medium-term credit.

4. Such was the situation after the second world war, when the fourth phase of the development of special institutions began.

At first — as was also the case with the *Crédit National* in France — the business of the I.M.I. received fresh impetus. Marshall Aid counterpart funds and loans from the Exim-Bank were put at its disposal; it issued several series of securities, and became one of the main sources of long- and medium-term capital for the great industrial concerns, and it by no means neglected the smaller industries (4).

Then in 1946 the three great banks controlled by the I.R.I. (see above) together formed a Joint-Stock Company, the *Banca di credito finanziario* (*Mediobanca*), for the purpose of granting medium-term credit to a select clientele, as well as undertaking the business of what we in France call a "banque d'affaire": organising capital issues, stock exchange placings and the floating of new enterprises.

Recently some other banks copied the three mentioned above and formed, on the same model as the *Mediobanca*, the *Enti finanziamenti industriali* (E.F.I.) which is still in its infancy (5).

Meanwhile, four "Public Law" Banks, (the *Banca Nazionale del Lavoro* which is growing rapidly and recently seems to have taken first place among the Italian banks, the *Banco di Napoli*, the *Banco di Sicilia* and the *Banco di Sardegna*), have each opened certain "special sections" (with separate accounts) for long- and medium-term credit.

Finally as there appeared need for further sources of medium-term credit for small and medium industry (defined by the law as having less than 1,500 million lire of its own capital and employing less than five hundred people), a dozen regional institutions have been opened during the course of the last few years. The regional or local banks participate in the ownership of these institutions which provide loans of up to 50 million lire, with maximum maturity of ten years. The three most important of these institutions are: at Milan, the *Istituto per il credito alle medie e piccole industrie della Lombardia* (Institute for Credit to Medium and Small Industries in Lombardy); at Naples, the *Istituto per lo Sviluppo Economico dell'Italia Meridionale* (Institute for the Economic

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(4) In ten years it undertook a thousand operations for the benefit of large enterprises and 5,300 for the benefit of medium and small ones; but naturally the sums involved for the large undertakings were more considerable than those by which medium and small concerns benefited.

(5) Actually the banks have taken over and reorganised for this purpose an old but inactive Corporation. We should also mention here the *Centrobanca* created on a similar plan by the network of Popular Banks.

Development of Southern Italy, ISVEIMER); and at Palermo, the *Istituto Regionale per il Finanziamento alle Medie e Piccole Industrie in Sicilia* (Regional Institute for the Financing of Medium and Small Industries in Sicily, IRFIS). It is anticipated that the last two, and similarly a Sardinian Institute of less importance (*Credito Industriale Sardo*, CIS) will progressively replace the special sections of the *Banco di Napoli*, *Banco di Sicilia* and *Banco di Sardegna* referred to above.

The establishment of these regional institutions was somewhat difficult owing to the scarcity of savings on which they could hope to draw in their respective provinces. Since 1952 it has become apparent that if they are to develop their business they must be reinforced by a central organisation (which would not itself be engaged in direct lending). Accordingly there was established in 1953 in Rome the *Istituto centrale per il credito a medio termine alle medie e piccole industrie* (Central Institute for Medium-term Credit for Medium and Small Industries), usually called *Mediocredito*. Its role is developing from year to year: in addition to the mobilising of credit for medium-term investment in medium and small industry it has been called upon to provide medium-term finance for exports (6), not only through the regional institutions but also through I.M.I., through the special sections of the banks, through *Mediobanca* and through E.F.I. So far, however, only small sums have been involved in this export credit business.

While the regional institutions of northern and central Italy appear to be a homogeneous network of establishments concentrating on credits under 50 million lire and grouped round *Mediocredito*, the institutions of the south (ISVEIMER and IRFIS) are quite different. They rely on *Mediocredito* scarcely at all, for the development of southern Italy has been made the responsibility of a public organisation (the *Cassa per il Mezzogiorno*) which receives large subsidies from the budget and from the State Treasury and obtains loans from the International Bank for Reconstruction and Development (I.B.R.D.). The *Cassa per il Mezzogiorno*, deploying its resources in accordance with a ten-year plan, provides funds for public works, water-works, roads and tourist facilities, and it makes

(6) Cf. " Export Incentive Measures in Italy ", in *Banca Nazionale del Lavoro Quarterly Review*, Nos. 36-37, January-June, 1956.

advances through the ISVEIMER and IRFIS to new industries and those which are to be expanded.

ISVEIMER and IRFIS, having until now found at the *Cassa per il Mezzogiorno* all the help they need, are able for the moment to escape the control of *Mediocredito*, resorting to it only for very limited accommodation to cover short-run contingencies. The managements of ISVEIMER and IRFIS are thus not limited by the rules imposed on *Mediocredito* and its network of institutions: the rules, that is to say, restricting their operations to medium and small industries and the amount of individual loans to 50 million lire. In the south it is not unusual for loans to exceed this sum and there are some projects receiving several milliards of lire from the funds which have been derived from the I.B.R.D.

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This brief survey shows that there exists in Italy more than a score of special institutions which for simplicity (perhaps excessive, but to which we are forced in a short exposition) we can put into four categories.

1. Three great institutions of national character, I.M.I., ICIPU, and CREDITOP, and one can add the I.R.I. The total loans of the three strictly "long-term" institutions reached at the end of 1955 808 milliards of lire (not counting the loans to State Railways). The total loans and participations of I.R.I. amounted, at the end of 1955, to round about 359 milliards of lire, in addition to which it has arranged "financings" amounting to 107 milliards.

2. Three Joint-Stock Companies (*Mediobanca*, E.F.I. and *Centrobanca*) and the special Section of the *Banca Nazionale del Lavoro*, which conducts medium-term business all over the country (as regards *Centrobanca* and the B.N.L. Section, for small and medium enterprises only). Their commitments were round about 63 milliard lire at the end of 1955.

3. About ten regional institutions of northern and central Italy, under the aegis of *Mediocredito*, whose loans totalled about 12 milliards at the same date.

4. The three institutions of southern Italy and the islands (ISVEIMER, IRFIS and CIS) backed by the *Cassa per il Mezzogiorno*,

and the three special sections of the *Banco di Napoli*, *Banco di Sicilia* and *Banco di Sardegna* which are being progressively superseded. The combined 1955 loans of these six organisations were about 96 milliard lire.

That makes a total of about 980 milliards of lire on loan (not counting loans by I.R.I. and the 192 milliards granted to the State Railways) and we have not included in this account:

(a) F.I.M. (an organisation, now in liquidation, for financing the engineering industry) (7) and the *Consorzio sovvenzioni su valori industriali* (now inactive) whose residual credits are valued at 37 and 12 milliard lire respectively.

(b) Several institutions dealing in medium-term loans of a special nature: the Section of the *Banco di Sicilia* dealing with mines (16 milliard of loans); the Sections of the *Banca Nazionale del Lavoro* covering the film industry (10 milliards), and hotels and the tourist trade (10 milliards); the Section of the *Istituto di Credito Fondiario delle Venezie* (13 milliards), etc.

The resources of the industrial credit institutions granting long- and medium-term loans were provided, broadly, as to two-thirds by their own capital and by the issue of fixed-interest securities; the rest was supplied by the State, by Marshall Aid or by I.B.R.D.

The greater part of the loans has gone into electricity, gas, steel, engineering and transport.

* * *

Before finishing with the institutions and passing on to the loan procedure we shall briefly consider the statutory provisions whereby the State exercises control over the distribution of loans and over the employment of public funds whilst assuring a representation of private business and of regional interests. The balance of influence varies greatly from one institute to another.

The capital of the three great Institutes was provided principally by the *Cassa Depositi e Prestiti* and the *Istituto Nazionale Assicurazioni* (National Assurance Institute), that is to say, in the

(7) Cf. Roberto Tremelloni, " Premises and Tasks of the Special Fund for Financing the Italian Engineering Industry ", in *Banca Nazionale del Lavoro Quarterly Review*, No. 3, October 1947.

last analysis by the State, but with the participation of certain banks and savings banks. In each organisation a meeting of the participants, acting in the same way as a meeting of shareholders, appoints a certain number of the members of the Board. The other members, including the President, are nominated by the Minister of the Treasury. He also has to preside over ICIPU and CREDITOP. In the three organisations, and also in I.R.I., the preponderant influence of the public authorities is clearly established.

The capital endowment of the central *Mediocredito* is entirely provided by the State which nominates the members of the General Assembly of participants, of whom a third are proposed by the Interministerial Committee on credit and saving, and another third are chosen from the banks and savings banks.

The Government nominates the members of the Board from the General Assembly, and the President of the Board who must be from outside the General Assembly. Thus (and it is the same in the *Cassa per il Mezzogiorno*) the preponderance of the State is indisputable, but representation of the business world is not neglected.

The system of the regional Institutes varies from a tolerably broad independence from public control to a nicely calculated distribution of influence between the State, private interests and regional authorities. At Milan, where the capital of the Institute does not include participation by the State, the organisation — in the shape of a " public law organisation " — is an autonomous enterprise. This arrangement is natural in Northern Italy where economic initiative is highly developed. A powerful and very old savings bank in the principal city of Lombardy supports the medium-term credit Institution. In southern Italy the *Cassa per il Mezzogiorno* supplies 40% of the institutions' capital, the *Banco di Napoli* and the *Banco di Sicilia* 40% between them, and the other banks in the area 20%. The Minister of the Treasury nominates the President (in Sicily this must be done in agreement with the political President of the region) but the Council is appointed by the participants proportionately to their share in the capital endowment. Thus there appears to be a predominance of local influence moderated by the control of the *Cassa per il Mezzogiorno*.

This completes our account of administrative arrangements peculiar to each institute and we now proceed to the operating practices.

* * *

Long-term credit in Italy is based on the same sources of finance, the same methods of investigation, and the same guarantees as in France. Funds are provided by the issue of bonds or by advances from the State. The investigation of requests for accommodation involves some enquiries by the consultant engineers, as in the *Crédit National.* The guarantees nearly always take the form of mortgages.

But in Italy *medium-term* credit is treated nearly the same as long-term, that is to say, more strictly than in France, and the course of its development has been determined by the rigorously orthodox policy of the Bank of Italy. The latter, fortified by the Banking Statute of 1936, seeks to prevent commercial banks from granting medium-term credit and resolutely excludes it from its own portfolio. In acting thus, it is influenced not so much by abstract considerations of monetary doctrine as by the painful lessons of experience. As is well known, the Italian banks have experienced certain periods of illiquidity to which they have no wish to return. That is why the Bank of Italy, exercising its power in the public interest, has encouraged the foundation of special institutes to which is confined the granting of long-term credit.

The use, in favour of medium-term credit, of the procedure of the third signature given by an organisation of the type of the French Crédit National (or of the *Caisse des marchés*, or the *Banque du Commerce Exterieur*) *is completely rejected in Italy.* The special institutions give no medium-term credit *which would not oblige them to eat into their own resources immediately.* And they cannot, otherwise than by issue of debentures, replace resources by resort to rediscount at the banks, still less at the Bank of Italy. Of course necessity has occasioned some relaxation of these conditions. That is why the *Mediocredito* was founded and the *Cassa per il Mezzogiorno* is allowed to help the southern institutions. But these two centres of rediscount have not themselves, for the time being, resources other than those provided by the State.

Having stated these principles let us examine in order Italian ideas and practice concerning the duration of loans, their objects, the possible recipients, the investigation of cases prior to the granting of loans, the guarantees taken, rates of interest and the intervention of the two special rediscounting institutions.

A) *The duration of loans.* Loans for less than a year are within the competence of commercial banks; the latter do not grant credits for more than one year. The division between medium- and long-term loans is neither as rigid nor as important as in France, since neither from the point of view of the origin of the funds employed nor, as we shall see, from the point of view of guarantees required is there much difference between the two categories. The Italian law of July 25, 1952 concerning the *Mediocredito* fixed the dividing line between the two categories at ten years. But there are some Italian bankers who, having regard to the rapidity with which modern machinery becomes obsolete, prefer redemption in five years. In these circumstances it is more instructive to examine the actual policy followed by the institutions than to search exhaustively for hard and fast rules.

The I.M.I. rarely grants loans for less than five years duration or for more than fifteen or sixteen years, so that it appears to a Frenchman to be an organisation for long-term rather than medium-term credit. The same seems to be true of CREDITOP and ICIPU.

In certain institutions in northern and central Italy the duration seldom exceeds five years; there the permitted maximum is ten years but in practice banks keep well below this limit. Moreover, the *Mediocredito* is only ready to give " rediscounts " for up to two years, although it may renew the accommodation after a new examination of the borrower's position.

In the southern institutions which rely on the *Cassa per il Mezzogiorno* loans are granted for periods of five to ten years. Until the recent creation of these institutions, special sections of the *Banco di Napoli* and of the *Banco di Sicilia* operated in the same way; since then however they have confined themselves to shorter credits.

The two private law companies contract few loans of less than five years, but the course of amortisation keeps the average life of outstanding loans down to about three years.

B) *The Object of loans.* They are all destined to be invested in plant or equipment, *to the exclusion of all use as circulating capital.* It has often been objected that this principle is too narrow in the context of medium-term credit; a firm's liquid resources are not divided and it is impossible to ensure that medium-term credit is not used to finance stocks. This argument has also been heard in France.

The two private law companies, *Mediobanca* and E.F.I., are more free and appear to adapt themselves easily to the needs of their customers.

C) *Beneficiaries; the importance of loans.* The large institutions have not shunned small business: they have granted numerous loans of relatively modest amount to enterprises of all sizes. But, although it is not possible to support this impression by statistics, it seems that large loans, granted to a few big concerns, constitute much the greater part of their operations. The beneficiaries come from all the branches of industry, but three big items, forming 75% of I.M.I.'s balance sheet, relate to transport and communications, electricity, steel and engineering. As we have already seen, electricity is the main customer of ICIPU, and public works and railways are those of CREDITOP.

The *Mediobanca* at Milan, though its figures are not comparable to those of the great institutions, is mainly interested in the big organisations, in their subsidiaries, or in enterprises working for them.

Legally, the regional institute must limit any one loan to 50 millions and can lend only to firms employing less than 500 people and having at their disposal funds less than 1.5 milliard lire. These restrictions are imposed on the institutions of northern and central Italy but, to the extent to which they use the funds of the *Cassa per il Mezzogiorno* and of the I.B.R.D., the southern institutions escape the limitations imposed by law on the *Mediocredito*. Thus they do not so completely exclude the great enterprises, especially when the project in question is investigated in conjunction with the I.B.R.D.

D) *The investigation of dossiers prior to the granting of loans.* The I.M.I., which is concerned rather with long than with medium-term credit according to French standards, uses methods of investigation precisely similar to those of the French *Crédit National.* Demands for loans reach it either through one of the five representatives which it maintains in the largest provincial cities or through the Bank of Italy. Judging by statistics shown in its annual reports, it is very strict and the percentage of refusals is high.

Whatever the amount or term of the loan requested an investigation is always made by a consultant engineer attached to I.M.I.

In the regional institutions requests for medium-term credit are made on standard-type forms whose pattern it is easy to picture. In general the firm's ordinary bank is consulted, but an investigation always takes place, either by a qualified accountant or, where the business is of exceptional importance (as in Southern Italy), by a technical expert.

In the special Sections which work in close contact with the banks to which they are attached, methods are freer and approximate, it seems, to those of French banks when they prepare a dossier for medium-term credit addressed to the *Crédit National*.

E) *Guarantees*. As a general rule the security is real property, generally by mortgage, even in the case of medium-term credit. This seems to be true for some 80 to 85% of loans agreed to by regional institutions and even by the special Sections. These arrangements are to some extent customary in Italy, perhaps partly because of the sharp division between short- and medium-term credit: once credit is given supervision cannot be maintained, and it is therefore necessary to protect it by sound guarantees. The requirements of the French *Crédit National* in the matter of mortgage guarantees for long-term credits are nearly the same, but much less severe for medium-term credit.

Italian banks complain of the extent of the privileges allowed to these institutions. The reply to this is that the normal cover for short-term credit lies, not in fixed property which may be more or less heavily mortgaged, but in stock or self-liquidating assets. We can say that the sharp division between the two types of credit raises problems of the relations between banks and institutions in their use of resources having regard to the demand for investment on the one hand and the need for day-to-day finance on the other. The founding of the institutions is still recent and it will take time to establish the habit of co-operation.

F) *Rates of Interest*. These vary considerably in Italy as in France, following the pattern of the sources which supply the loans; like the *Crédit National*, the I.M.I. divides its accounts into ordinary business and special business based on State funds. For certain categories of loans the State bears part of the interest charged by the institutions. The scale of rates paid by the borrowers varies from 3% to 8½%. It is not possible to estimate the average rate and we must moreover frankly confess that it would also be pure guesswork where France is concerned. We may however guess that such an average rate would be higher in Italy than in France, perhaps by a full point or a little more, a difference that may be considered as reflecting the spread between the rates at which bonds can be issued.

G) *Intervention of the Central Institutions.* There is little to say of the procedure of the *Cassa per il Mezzogiorno* which advances funds to the southern institutions in the same way as in France the State supports the Popular Banks or the *Crédit Agricole* in certain of their operations.

More strange to French eyes is the method of the *Mediocredito* which supports the regional institutions in many ways: by rediscounting bills, by granting loans or underwriting shares or cash bonds issued by them. Whether it is making advances or taking up bonds the *Mediocredito* has assigned to it by the institutions, as special guarantee, an amount of credit operations equal to the total of funds advanced, as well as whatever security is attached to those operations. It limits its support to 50% at most of each loan and to a period of two years, but is free to prolong its assistance if it finds this appropriate. Thus it exercises a very close control over the kind of projects to which the money is to go, and it compiles very complete dossiers, but it does not proceed, except in rare cases, to enquiries into the actual conduct of the business. It concentrates its efforts on the stage at which the money is being raised. In its desire to maintain complete freedom of judgment at all times, *Mediocredito* refuses to take part in the investigation made by the institutions prior to the granting of a loan. The institutions are administered independently, as is *Mediocredito* itself.

* * *

Such are the structure, principles and methods of the long- and medium-term credit institutions; we must now consider their place in the whole structure of financial institutions.

In Italy medium- and long-term loans granted by *all* the Special Credit Institutions (industrial, land and building loans, loans for the improvement of agriculture and the storing of crops, and loans to State railways), plus those through the Savings Banks, certain banks and their central Institutes (credits on note of hand and mortgages), together totalled at the end of 1955 more than 2,050 milliard lire, of which more than half was for industry. Short-term credit granted by the Savings Banks, commercial banks and their central Institutes (bills, overdrafts, advances, loans against pledge of wages and bills rediscounted) at the same date exceeded 3,600 milliard lire, excluding funds employed in foreign exchange operations which reached 123 milliard lire.

In France the proportions were almost the reverse: 3,800 milliard francs at long- and medium-term (of which 845 milliard is lent by the commercial banks and the Bank of France with the endorsement of the *Crédit National* or of the *Crédit Foncier*) and only 2,400 milliard francs at short term.

To get these figures on to a comparable basis we can relate them to the gross national products (8). We then see that long- and medium-term credit, especially for industrial purposes, is less developed in Italy than in France, but that, on the other hand, short-term bank credit in Italy is nearly twice as important as in France. Incidentally we notice that a similar conclusion would result from a comparison between German and French statistics.

We must not forget, of course, that there are other sources of capital besides the banks and special institutions; notably there is direct resort to the capital market and there are public funds. A comprehensive comparison would therefore have to include not just two but at least four sectors in the supply of funds.

Even if the contrasts revealed by the statistics cannot be imputed to a single cause, one cannot deny that France is the only European country where the banks are authorised to lend openly at medium-term and on advantageous conditions (since the endorsement of the *Crédit National* assures the liquidity of their commitments) and that customers in France pay less for this kind of loan than for an ordinary unsecured overdraft. In a period of reconstruction and expansion and monetary somersaults, the classification of loans into long-, medium- and short-term appears to certain borrowers — dare one say to certain bankers? — as raising difficulties which are merely doctrinaire. Is not one of the consequences

(8) 12,900 milliard lire and 16,400 milliard francs.

of the very liberal French control of medium-term credit to have given the banks, not indeed complete freedom, but very considerable discretion? The facility thus enjoyed by all the French banks is particularly valuable to them as their liquidity position is certainly more vulnerable than that of foreign banking systems with which we have been comparing them.

In Italy, as in several other countries, notably Germany, the commercial banks receive some savings deposits, and the savings banks (which are authorised to discount bills and to make loans) belong to the banking system. A total balance-sheet for the banking system consequently includes (at the end of 1955), not only 2,690 milliard lire of demand deposits but also *2,470 milliards of savings deposits* (9). Under these conditions the liquidity of the banking system can easily be maintained without the banks, or more exactly the savings banks, abstaining altogether from fixed investments. They therefore quite legitimately have large holdings of securities, including many that have been *issued by the Special Institutes for long- and medium-term credit.*

A broad capital market is more necessary to Italian special institutions than to ours, because they do not have the same facilities for rediscounting and the State helps them less than is the case with us. At the end of 1954 French industrial credit was financed in the following way: 23% by savings, 55% by State advances and 22% by bank rediscounts. Italian industrial credit was financed to the extent of 65% by savings and to the extent of 35% by State and foreign loans.

Statistics of the issue of shares, debentures and " pluriennial " Treasury bonds show — when the figures are reduced to common terms — that the Italian capital market in 1953 and 1954 absorbed about twice as many securities as the French. This fact is surprising to a Frenchman, for individual income is surely higher in France; it is however, no part of our present purpose to furnish a complete explanation. The proportion of share issues is higher in Italy than in France, probably because fiscal legislation is more favourable to companies in the former. In Italy gold has never absorbed — and held — savings in the way it has among French people. Lastly

(9) In this classification the total of deposits " on current account " (about 257 milliards) is combined with other demand deposits; foreign accounts (about 361 milliards) are excluded.

perhaps saving is differently distributed; possibly company savings have not the same importance in the two countries. Supplies in the capital market depend as much (and sometimes more) on the income structure as on the total of incomes. At the end of an article, already long, we can only mention these points, and they are of course open to argument. The fact nevertheless remains that the Italian capital market has yielded more ample supplies of funds than the French.

* * *

What conclusions can we draw?

The legal separation of short- from medium-term credit is certainly a healthy rule from the point of view of the liquidity of Italian banks; liquidity is further assured by the fact that a large part of the banks' liabilities is not payable on demand, being in fact an accumulation of savings.

In France orthodox doctrine has not been observed so rigorously. Constrained by the deterioration of the capital market and anxious to obtain, above everything else, quick results in industrial reconstruction we in France deviated for the time being from classical ways. We have however intended to restore a more normal position after some years, and the volume of medium-term bills representing equipment finance has already ceased to grow.

There are also differences of a technical kind. In France the signature of the *Crédit National* serves to separate the notions of risk and illiquidity. In Italy the medium-term Institution assumed both the risk and the burden on cash resources. *Mediocredito* never engages in advance to made the credit liquid. Is is not possible to conceive a system where responsibility is more concentrated, and probably this is right.

On the other hand, the institutional separation of short- from medium-term credit can create difficulties in relations between the banks and the special institutions. It can cause the special institutions to seek real property guarantees even for medium-term credit. For once the credit is granted they are less well placed than a banker to follow the course of the business. Every method has disadvantages as well as advantages.

Such are the principal reflections suggested by an examination of the two systems. Both pretty clearly need to rely on a well-supplied capital market. Italy seems to have been relatively more fortunate than France, in this regard, during the last few years.

This point, which is on the borderline of our present subject, would merit a special investigation of its own: in any case it is apparent that the possibilities for issuing fixed-interest securities are fortunately increasing in both countries.

The most original feature of the Italian system is its network of regional institutions, which we now know could not have developed without the support of a central institute, the *Mediocredito*. This arrangement, in which influence is divided between public authority and the banks, constitutes an interesting experiment in the encouragement of industrial development in regions and through small firms which need simultaneously State aid and private initiative. The experiment is in its infancy but, after some hesitation, the start has been promising enough. Now, when France is trying to stimulate activity in certain provinces which lag behind the great industrial zones, this example merits close attention.

I have allowed myself these comparisons between the two countries in the hope of adding interest to an otherwise purely technical study, and am not implying that any difference between the two systems makes one, *in abstracto*, preferable to the other. The story of Italian banks differs from that of French banks. Financial practices and needs on one side of the Alps differ from those on the other. Looking at the variety of Italian institutions a Frenchman realises for example, that there are — economically speaking — two Italies, that of the North and that of the South. Therefore it is not surprising that French and Italian answers to the same questions can diverge at several points.

Up to the present it does not seem that the franc has suffered from the liberality of facilities in France for obtaining medium-term credit to support ravaged industries. At the end of 1943, before the ordeal was ended, it was the French monetary authorities themselves who, thinking then of the future, took the initiative (fortunately, we can say from experience) to establish these facilities. These same authorities are perfectly ready, still, to assume new responsibilities of control in a sector which was quietly ignored before the war. The need for investment is no less intense in Italy. Stimulated by the necessity of raising the level of employment, obliged to repair war damage, deprived of its colonies and concentrating its efforts on the metropolitan territory, the country is taxing its ingenuity to develop industry and gives to a visitor at this time the impression of a very remarkable vigour. The effort to achieve a more reasonable balance between North and South has led to well-chosen programmes of capital development, and a serious start has been made in the execution of these programmes.

The economy is now fully active, but neither the Government nor the central bank can forget the liquidity crises of the past, in which the Italian banks suffered more acutely than did the French. They therefore follow a cautiously orthodox policy, striving to reconcile the requirements of expansion with the strict protection of the lira.

Paris ALFRED ROUX

THE ITALIAN TAX SYSTEM*

I. Introduction: Fiscal Reform Since 1951

With the achievement of postwar monetary stability, the Italian Government began an integrated and gradual reform of the entire tax system. The first steps were taken in January 1951 with the "Vanoni law" reforming the Govenment's direct tax system and in July 1952 with a new law on local finance. The former law is designed chiefly to improve the system for the determination of taxable incomes and thus reduce evasion. The law on local finance seeks to regulate more strictly the relationship between the taxation powers of the National Government and those of local agencies (Communes and Provinces), and places definite limits on the taxing powers of the local agencies.

A second part of the reform has been a progressive reduction in the rates of the transactions tax (*imposta generale sull'entrata*) as a means of encouraging business activity and reducing the burden of indirect taxation. To this phase of the reform also belongs the introduction of a corporation tax, new to the Italian tax system, and a tax on bonds instead of on security transactions. This corporation tax is imposed on the capital and income of all corporations operating in Italy.

A third part of the reform concerns certain provisions of law, effective since January 1956, calling for improved assessment procedures and stricter penalties to be applied to evaders.

II. The Tax System of the National Government

A. DIRECT TAXES

1. Types of direct taxes

At present the following direct taxes are in effect:

(*a*) Property and land taxes:

(1) tax on land, mainly on "imputed," not actual, rent of agricultural land; usual rate is 10 percent;

(2) tax on buildings, on actual or "imputed" rent of buildings other than farm buildings; rate is 5 percent.

(*b*) Income taxes:

(1) tax on *ricchezza mobile* (movable property) income—an income tax on individuals and firms with rates set according to sources of income. (See Enclosure No. 1.) There are the following four categories:

(*a*) Category A: incomes derived exclusively from the use of capital; rate of tax is 22 percent;

(*b*) Category B: mixed incomes derived from the use of capital and from labor, rate of tax is 18 percent from jurid-

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ical persons, for physical persons, who have an exemption of 240,000 lire the tax rate is 9 percent for incomes from 240,000 to 960,000 lire and 18 percent for that part of incomes that exceed 960,000 lire.

(c) Category C/1: variable incomes from labor, i. e., professional incomes, the tax rate after exemption of 240,000 lire is 4 percent for incomes from 240,000 to 960,000 lire and 8 percent for that part of incomes that exceeds 960,000 lire;

(*d*) Category C/2: fixed incomes from labor, i. e., wages, salaries, pensions; the tax rate is the same as for category C/1 incomes.

(2) progressive surtax (*imposta complementare sul reddito*), an income tax on individuals only, with rates set according to size of income, regardless of source (See Enclosure No. 2). The rates vary from 2 percent for taxable incomes of 240,000 lire to 50 percent for annual incomes in excess of 500 million lire. Annual incomes that do not exceed 540,000 lire are exempt. For incomes above 540,000 lire, there is a personal exemption of 240,000 lire and an exemption of 50,000 lire for each dependent.

(3) a corporation tax, which is an annual tax at the rate of 0.75 percent on total capital and reserves and 15 percent on annual profits exceeding 6 percent of the corporation's capital plus reserves. Various exemptions from the tax and reductions of the tax rate are applicable to cooperatives, banks, and other financial companies. The tax is also applicable to foreign firms operating in Italy.

(*c*) Estate and inheritance taxes:

Estates are subject to a progressive tax varying from 1 percent on estates of up to one million lire to 35 percent on estates over 500 million lire. The rates are halved when the estate passes to direct descendants, or to husband or wife, or to public charitable and educational agencies. Government securities are exempt from the estate tax.

Inheritance tax rates vary according to degree of relationship, from a minimum of 1 percent, for transfers to direct descendants in amounts not exceeding one million lire, to a maximum of 80 percent, for transfers to distant relatives or non-relatives in amounts exceeding 500 million lire. An exemption of up to 750,000 lire applies to transfers to direct descendants. Both these taxes are applicable to property located in Italy, regardless of the nationality or place of residence of either the deceased or the beneficiaries.

(*d*) Temporary taxes:

An extraordinary tax on property was levied on a one-time basis in 1947. It was applied at the rate of 4 percent on all assessed property values as of April 1947. A substantial premium was given if the taxes were paid in a lump sum but provision was made for spreading payments over a period of years and such payments still bring a considerable sum into the Treasury.

In 1952 the Government levied an extraordinary tax on payrolls to help finance its investment program. The tax was applicable only during the period March 1, 1952–June 30, 1954 and expired at the latter date. Rates were originally 4 percent on salaries of executives, clerks, etc., who are paid on a monthly basis and 2 percent on wages of all other workers. For the period from January 1 to June 30, 1954 the rates were reduced to 3 percent on salaried employees and 1.50 percent on wages of other workers.

To carry out a plan for the improvement of rivers, streams, forests, and mountain basins in Calabria, Law No. 1177 of November 26, 1955 authorized an extraordinary tax of 5 percent on all communal, provincial, and national taxes and surtaxes. This temporary tax applies for twelve years and is designed to provide funds to finance the Calabrian program for fiscal years 1956 through 1967. The *Cassa per il Mezzogiorno* is charged with carrying out the program, which is to cost 204 billion lire.

2. Assessment and collection of direct taxes and penalties for tax evasion

The assessment of direct tax liability is made by the Government on the basis of (*a*) cadastral surveys, for the tax on land, and (*b*) annual income declarations, subject to adjustment by tax authorities within a maximum period of three years, by or on behalf of individuals, unlimited liability companies, and corporaitons, for the tax on income from buildings, the *ricchezza mobile* tax, the progressive income surtax, and the corporation tax. The declaration must be submitted, whether by private persons or by corporations or firms, between January 1 and March 31 of each year. Corporations and firms that are required by law to compile annual balance sheets must submit their declarations, accompanied by the balance sheet, within three months after its approval.

Collection procedures for direct taxes are as follows: tax assessment rolls prepared by the State are given to private collectors who must collect the amount of taxes shown, including an approximate 7–10 percent collection fee or bear any shortfall as a personal loss, except for *force majeure*. Collection from all salaried employees is made at the source for the entire *ricchezza mobile* tax, and for the progressive income surtax at a rate of 1.5 percent.

The tax due, after allowance for withholding, if any, is paid in bimonthly installments. A taxpayer may contest in special tax courts the assessment made by the Government. This, however, is rather infrequent since the Government usually has a good basis for its assessment, even though it does not have the right to investigate a taxpayer's bank account or safe deposit vault. Cases under Government investigation may not be publicized.

The law of January 5, 1956 (Law No. 1, Official Gazette No. 6, January 9, 1956) strengthened the measures for combatting fiscal evasions and frauds. The law introduced, for the first time in Italy in fiscal matters, the requirement of an oath in the case of failure to file a declaration or when the declared income is less than half the amount assessed by the Government. Making a false oath is punished under the penal code with imprisonment ranging from six months to three years. Failure to file an annual declaration is punishable by a fine ranging from 30,000 to 300,000 lire, and the fine may be doubled or tripled in the case of second offenders or repeated offenders, respectively. Failure to file a return on an income assessed at more than 6 million lire may draw the additional penalty of imprisonment up to six months. Fraudulent acts intended to show a reduced income (e. g., undervaluation of assets or overvaluation of liabilities) are punishable by imprisonment up to six months and fines ranging from 50,000 to 600,000 lire. Other fines may be imposed on administrators and auditors of corporations which are taxed on the basis of balance sheets submitted with their declarations, as well as on public officials, directors, and officials of banks whenever they fail to fulfill the requirements of the law.

B. INDIRECT TAXES

By far the most important indirect tax is the general transactions (I. G. E.) tax which accounts for almost a quarter of the Government's total tax revenue. It applies to all transactions not specifically exempted by law. Exemptions pertain to capital transactions (sales of real estate, stocks and bonds, contraction and payment of debts, etc.), to dividend receipts, to interest receipts from bank deposits (but not from bank loans), to wages and salaries, to pensions and annuities, to sales of certain types of products and services such as bread, pasta, milk, railroad transportation, and finally to all transactions involving the export of a commodity or service. The tax is collected and paid to the State by the seller who adds it directly to the price of his product. Thus the tax accumulates on goods that pass through several transactions on their way to the final purchaser.

The normal rate of the I. G. E. tax is 3 percent of the value of the transactions. However, for retail store sales and certain other transactions where the tax is collected by subscription—i. e., on the basis of total sales volume in a given period—the current rate is 1 percent.

Other indirect business taxes include the stamp tax and the tax on registration of contracts.

Manufacturing taxes apply to butter, mineral oils, and their derivatives, seed oils, animal fats and oils, sugar, alcohol, yarns, electric lighting appliances, coffee substitutes, gas, electricity, cement, methane gas, and mercury and its derivatives. The tax, for example, on petroleum products is 11,200 lire per quintal[1] of gasoline, from 110 lire to 3,000 lire per quintal of fuel oil, depending on its destination, 15,700 lire per quintal of white lubricating oil, and 12,400 lire for others. On sugar, the tax varies from 8,835 to 9,200 per quintal, depending on the degree of refining. (There are concessions for industrial uses such as the manufacture of condensed milk and preserves.) The tax on textile fibers varies widely, depending on the quality of the product: e. g., cotton, from 20 to 2,200 lire per kilo; wool, from 28 to 160 lire per kilo; and silk, 32 to 168 lire per kilo. Electricity is taxed at the rate of 4 lire per kilowatt-hour for illumination, and 0.30–0.50 lire per kilowatt-hour—depending on the amount consumed—for motive power.

Other indirect taxes include entertainment taxes, a vehicle circulation tax, and customs duties. Similar to a tax is a margin that the Government sets between the cost and the selling price on certain commodities—salt, tobacco, and cigarette paper—sold through State monopolies.

[1] A quintal equals 220 pounds.

III. The Tax System of the Local Governments

A. DIRECT TAXES

The local governmental bodies (Provinces and Communes) levy a number of direct taxes. Such local direct taxes consist of surtaxes on land and buildings and taxes on industry, trade, and the arts and professions corresponding to the Government progressive surtax on incomes except that the maximum rate is limited to 12 percent of assessed incomes.

B. INDIRECT TAXES

The major local indirect tax is the consumption tax levied on a wide variety of products and at various rates established by the communal authorities within limits set by the State, but subject to increase beyond these limits if warranted by the financial situation of the communal government. Consumption taxes apply to goods consumed in the commune whether produced in that commune or not. If brought in from another area, collection is usually made at the time of entry.

The communes are authorized to tax the following commodities: wines and spirits, alcohol, mineral waters, meat, poultry, game, fish, sweets, cocoa, chocolate, cheese and milk products, butter and butter substitutes, perfumes and fine soaps, gas for domestic use, electricity, construction materials, phonograph records, and furs. Communes in a poor financial condition are also authorized to tax sporting goods, shoes, baby carriages, paper, inner tubes, gas or electric stoves and ranges, toys, refrigerators, hides and skins, carpets and upholstery fabrics, clothing materials, household utensils and appliances, glass, crystal, and gold, silver, or generally precious articles.

A few examples of consumption taxes are shown below for three communes:

Commodity	Unit taxed	Rome	Naples	Leghorn
		Tax in lire		
Wine	100 liters	1,875.0	1,875.0	1,875.0
Gas	Cubic meter	1.5	1.5	1.5
		Tax as a percent of value		
Perfume	220 pounds	22.5	22.5	22.5
LP gas	Cylinder	50.0	50.0	50.0
Electricity	Kilowatt-hour	10.0	10.0	10.0
Phonograph records, LP	Each	7.5	7.5	7.5
Men's shoes	Pair	6.0	6.0	4.0
Refrigerator	Liter of capacity	6.0	6.0	6.0

IV. Comments on the Italian Tax System

A. THE TREND OF DIRECT TAX RECEIPTS

The trend of direct tax receipts of the National Government in recent years is shown in Enclosure 3. Since the beginning of Italy's postwar tax reform, direct tax receipts have almost doubled. However, receipts from direct taxes are now only about 19 percent of total

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tax revenues while in fiscal year 1938–39 more than 29 percent of total tax receipts came from direct taxes. A return at least to this latter percentage is an essential development in the interest of a better balanced and more equitable Italian tax system.

The following table shows the results, with respect to the progressive income surtax, of the first five income declarations since 1951:

Declaration	Number of returns	Taxable income (billions of lire)	Average taxable income (thousands of lire)
October 1951 [1]	1,038,771	[2] 315	303
March 1952	1,137,533	959	843
March 1953	1,199,505	1,167	973
March 1954	1,259,402	1,302	1,033
March 1955	1,264,481	1,380	1,091
March 1956	1,162,529	1,436	1,235

[1] Excludes civil servants; since 1952, civil servants with a yearly income in excess of 480,000 lire are required to file a return.

[2] 1951 returns were net of basic and dependency exemptions; since March 1952, returns have been on a gross basis before all exemptions. The Ministry of Finance has estimated the taxable income on a gross basis for the 1951 declaration at 924,000,000,000 lire.

Of special interest is the increase in the size of the average taxable income, which suggests more accurate filing of returns by the higher income groups. It should be noted that the increase in returns and taxable income reflected in the third and fourth declaration occurred despite a change in the minimum taxable income from 240,000 lire to 480,000, which has been in effect since July 1952. In March 1956 the Tremelloni Law further increased the minimum taxable income to 540,000 lire and the number of returns for 1956 is therefore below the returns for each year since 1953.

Taxable income, on the other hand, increased greatly, and the average taxable income showed an ever greater proportionate increase.

B. THE FISCAL BURDEN IN ITALY

The fiscal burden in Italy, as measured by the ratio of taxes and social security charges to gross national product, has recently been as follows.

	1952	1953	1954	1955
Ratio of National Government taxes to gross national product (including collection fees)	15.8	16.9	16.9	17.0
Ratio of social-security charges to gross national product	7.2	7.2	8.1	8.4
Ratio of local taxes to gross national product	3.3	2.7	3.0	3.1
Total	26.3	26.8	28.0	28.5

The relative severity of this fiscal burden must be appraised in light of the fact that GNP per capita in Italy is low (about 270,000 lire in 1955) and the tax system is quite regressive.

As an example of the direct tax burden, Enclosures No. 4 and No. 5 show the National and local taxes for a corporation situated in Rome. It is evident that the new corporation tax (see Enclosure 4) has considerably increased the tax burden on Italian corporations.

V. Tax Concessions

Any useful summary of the Italian tax system should include a mention of the tax concessions that have been granted under national or regional legislation as an inducement to the industrialization of Southern and Insular Italy. For the installation or enlargement of industrial enterprises in these areas the following fiscal facilities are provided:

A. TAX REDUCTIONS

1. IGE tax

(*a*) A reduction of 50 percent is granted on materials and machinery for new installations or for the restoration, enlargement, transformation, etc., of existing industrial plants (DLCPS [2] No. 1598, December 14, 1947).

2. Income portion of corporation tax

(*a*) The income portion of the tax on corporations is reduced by 40 percent for a fixed period of 5 years, beginning January 1, 1954. (The income portion of the corporation tax is collected at the rate of 15 percent on that portion of income exceeding 6 percent of capital and reserves.)

3. Registration and mortgage taxes

(*a*) A bill now before Parliament will, if enacted as law, reduce the registration and mortgage taxes to the fixed amount of 200 lire. This would apply for ten years from the effective date of the law.

B. TAX EXEMPTIONS

1. Income (ricchezza mobile) tax

(*a*) For ten years, the incomes of industrial plants established before January 27, 1958 are exempted from the *ricchezza mobile* income tax.

(*b*) The *ricchezza mobile* income tax will not be assessed against the increased income deriving from the enlargement, transformation, modernization, or restoration of industrial plants. Exemption will be granted only on that portion of the income that is demonstrably a product of these changes (DLCPS [2] No. 1598, December 14, 1947).

(*c*) A bill now before Parliament will, if enacted as law, exempt from Category B of the *ricchezza mobile* tax up to 50 percent of the profits of firms, taxed on the basis of balance sheets, if these profits are intended to be invested in Southern and Insular Italy. This exemption would apply for five years from the effective date of the law.

2. Customs duties

(*a*) Building materials, machinery, and equipment needed in new installations or for the restoration, enlargement, transformation, etc., of existing industrial plants are exempt from customs duties (DLCPS [2] No. 1598, December 14, 1947).

3. Registry taxes

(*a*) The first transfers of property necessary to carry out projects described in the preceding paragraph are subject to a fixed registry

[2] DLCPS = Decreto-Legge del Capo Provvisorio dello Stato (Decree-Law of the Provisional Head of the State).

tax reduced to a minimum, instead of a proportional tax (DLCPS [2] No. 1598, December 14, 1947).

4. Mortgage tax

(*a*) Same as Registry Taxes. The mortgage tax, if applicable, will be fixed, not proportional (DLCPS [2] No. 1598, December 14, 1947).

5. Regional taxes

(*a*) The cost of electric power in Sicily may be exempted from regional taxes if the power is used for industrial plants, if the pending new Regional Law for the industrialization of Sicily is approved.

Many similar reductions and exemptions are accorded to installations in the industrial zones of Trieste, Verona, Gorizia, Rome, Massa Carrara, and Leghorn.

VI. Conventions Between Italy and the United States of America for the Avoidance of Double Taxation

A. INCOME TAXES

To avoid double taxation and prevent evasion of income taxes, the Governments of the United States and Italy signed in March 1955 a convention that became effective as of January 1, 1956.

The Convention concerns the United States federal income tax and related surtaxes, and Italian income taxes on land, buildings, movable wealth (*ricchezza mobile*), agricultural income, and the progressive income surtax (*imposta complementare progressiva*). The Convention also relates to partial exemption in the case of a tax based on property and income (exemption from the income tax feature but not the capital tax aspect of the Italian tax on corporations); although expressed in reciprocal terms, this provision actually has effect only as to Italian law, because the United States does not impose a tax on property.

Regarding the taxation of income derived from activities carried on by physical persons, corporations, or firms, the Convention provides that the income of an enterprise operating in both Italy and the United States will generally be taxed by the country to which the enterprise belongs. Only when an enterprise of one of the countries carries on commercial or industrial activities in the other country through a permanent establishment may the latter country tax the income of the enterprise to the extent attributable to such an establishment. The test for measuring the income of a United States corporation that is attributable to the permanent establishment in Italy is the amount of in-

[2] DLCPS = Decreto-Legge del Capo Provvisorio dello Stato (Decree-Law of the Provisional Head of the State).

dustrial or commercial profits such establishment might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions and dealing at arm's length with the United States corporation.

The Convention also provides that the taxes imposed in both countries on dividends that are transferred from one to the other cannot exceed 15 percent of the amount involved. This rate is reduced to 5 percent if the stockholder controls at least 95 percent of the voting stock of the company paying the dividends.

Regarding personal incomes, the Convention provides for the exemption from taxes in the United States or in Italy for salaries, wages, and pensions paid by one of the countries to citizens of the other who are not permanently residing therein. Incomes derived from real property and royalties received from the exploitation of mines, quarries, or other natural resources are to be taxed by the country in which such resources are situated.

Furthermore, the Convention grants reciprocal exemption to incomes derived from the operation of ships or aircraft registered in Italy and the United States; this proviso suspends the arrangement between the United States and Italy providing for relief from double income taxation on shipping profits, effected by exchange of notes in 1926.

B. ESTATE AND INHERITANCE TAXES

In March 1955 a convention to avoid the double taxation of estates and inheritance was also signed between the United States and Italy. This Convention, too, became effective on January 1, 1956.

It concerns the United States Federal estate tax and the Italian estate and inheritance taxes. The Convention first establishes rules for determining the location of the various parts of the estate. For example, real property is considered to be situated in the place where the land involved is located, personal property in the place where it is at the time of the death of the owner; debts where the debtor resides; ships, airplanes, patents, trade-marks, and designs where they are registered. Goodwill as a trade, business, or professional asset is considered to be situated in the place where the trade, business, or profession is exercised.

The Convention provides a specific exemption for aliens not domiciled in the taxing State. The exemption must be the same as that offered under the laws of the State if the deceased had resided there, and in an amount not less than the proportion the value of the property taxed bears to the value of the property that would have been taxed had the decedent been domiciled in that State. For deceased persons who were domiciled in the State where they died, the taxing State shall allow a credit for the tax imposed by the other State.

[Enclosure No. 1]

Rate schedule of the Italian ricchezza mobile income tax

[Data in lire]

Category	Exemption	Income recipient	Rate
A. Income from capital		Individuals and corporations.	22 percent.
B. Income from capital labor	240,000	Individuals [1]	9 percent of incomes from 240,000 to 960,000 lire; 18 percent for the part of income exceeding 960,000 lire.
	[2] 36,000	Juridical persons	18 percent.
C/1. Professional income	240,000	Individuals [1]	4 percent of incomes from 240,000 to 960,000 lire; 8 percent for the part of income exceeding 960,000 lire.
	[2] 36,000	Juridical persons	12 percent.
C/2. Labor income	240,000	Individuals	4 percent of incomes from 240,000 to 960,000 lire; 8 percent for the part in excess of 960,000 lire.
Agricultural income			10 percent.

[1] For the purpose of the application of such rates, the term "individual" applies also to work cooperatives and companies (other than joint stock or limited liability companies and partnerships) when established for the purpose of producing goods or services and the activity consists chiefly of services rendered by the partners.

[2] The limit of 36,000 lire does not represent a general exemption, but rather the minimum exempted income. This means that if a juridical person enjoys an income surpassing that limit, the entire income is taxed.

[Enclosure No. 2]

Rate schedule of the Italian progressive income surtax

Taxable income (lire):	*Percentage rate*
240,000	2
1,000,000	3.17
5,000,000	6
10,000,000	8.11
50,000,000	16.92
100,000,000	23.43
200,000,000	32.49
300,000,000	39.34
400,000,000	45.04
500,000,000 and over	50

NOTE.—The surtax is not levied on persons whose gross income does not exceed 540,000 lire per annum. If gross income exceeds 540,000 lire per annum, he is allowed a 240,000-lire deduction plus a deduction of 50,000 lire per each dependent.

Interest on Government securities is subject to the progressive incomes tax but not to the ricchezza mobile tax.

[Enclosure No. 3]

The Italian Government's cash tax receipts, by category of tax

	Fiscal year 1938–39		Fiscal year 1950–51		Fiscal year 1951–52		Fiscal year 1952–53		Fiscal year 1953–54		Fiscal year 1954–55		Fiscal year 1955–56	
	Billions of lire	Percent of total	Billions of lire	Percent of total	Billions of lire	Percent of total	Billions of lire	Percent of total	Billions of lire	Percent of total	Billions of lire	Percent of total	Billions of lire	Percent of total
Direct taxes	6.82	29.3	196.4	16.3	243.7	17.6	356.9	21.9	349.3	19.5	380.9	19.1	425.4	18.9
Income (ricchezza mobile, land, building, progressive surtax)	(6.44)	(27.8)	(150.8)	(12.5)	(188.7)	(13.7)	(226.8)	(13.9)	(236.6)	(13.2)	(314.2)	(15.8)	(360.1)	(16.0)
Inheritance	(.20)	(.9)	(9.6)	(.8)	(11.3)	(.8)	(14.3)	(.9)	(18.5)	(1.0)	(20.2)	(1.0)	(23.4)	(1.0)
Temporary (capital levies and payroll tax)	(.18)	(.6)	(36.0)	(3.0)	(43.7)	(3.1)	(115.8)	(7.1)	(94.2)	(5.3)	(46.5)	(2.3)	(41.9)	(1.9)
Business taxes	5.77	24.9	440.6	36.5	496.8	36.0	577.4	35.4	634.9	35.4	708.9	35.6	794.7	35.3
Transaction (I. G. E.)	(2.48)	(10.7)	(297.5)	(24.7)	(334.2)	(24.2)	(378.5)	(23.2)	(401.8)	(22.4)	(448.7)	(23.5)	(495.6)	(22.0)
Other (stamp, registration, etc.)	(3.29)	(14.2)	(143.1)	(11.8)	(162.6)	(11.8)	(198.9)	(12.2)	(233.1)	(13.0)	(260.2)	(12.1)	(299.1)	(13.3)
Surtax on direct and business taxes	.18	.8	18.0	1.5	20.7	1.5	21.5	1.3	34.3	1.9	46.6	2.3	56.2	2.5
Consumption taxes (spirits, beer, sugar, coffee, gas and electric power, electric bulbs, textiles)	4.77	20.6	234.3	19.4	260.4	18.9	279.6	17.1	327.3	18.2	374.8	18.8	450.9	20.1
Custom duties	1.55	6.7	69.4	5.8	82.7	6.0	96.1	5.9	121.6	6.8	130.5	6.6	152.3	6.8
Monopolies	3.58	15.4	224.7	18.6	252.6	18.3	271.1	16.6	292.7	16.3	311.9	15.7	334.6	14.9
Tobacco	(3.11)	(13.4)	(203.5)	(16.9)	(231.4)	(16.8)	(251.9)	(15.4)	(261.2)	(14.6)	(286.0)	(14.4)	(304.5)	(13.6)
Salt and other	(.47)	(2.0)	(21.2)	(1.7)	(21.2)	(1.5)	(19.2)	(1.2)	(31.5)	(1.7)	(25.9)	(1.3)	(30.1)	(1.3)
Lotteries	.52	2.3	22.0	1.9	24.1	1.7	29.1	1.8	34.5	1.9	37.5	1.9	33.3	1.5
Total	23.19	100.0	1,205.4	100.0	1,381.0	100.0	1,631.7	100.0	1,794.6	100.0	1,991.1	100.0	2,247.4	100.0
Gross national product at market prices	[1] 149.80	--------	[2] 8,390.0	--------	[3] 9,699.0	--------	[4] 10,210.0	--------	[5] 11,093.0	--------	[6] 11,820.0	--------	[7] 12,902.0	--------

[1] Calendar year 1938.
[2] Calendar year 1950.
[3] Calendar year 1951.
[4] Calendar year 1952.
[5] Calendar year 1953.
[6] Calendar year 1954.
[7] Calendar year 1955.

Source: Treasury Monthly Bulletin.

[Enclosure No. 3 (a)]

Income-tax revenue, by type of tax

	Fiscal year 1938-39		Fiscal year 1950-51		Fiscal year 1951-52	
	Billions of lire	Percent of total tax receipts	Billions of lire	Percent of total tax receipts	Billions of lire	Percent of total tax receipts
Ricchezza mobile	4.01	17.3	123.3	10.2	149.5	10.8
Land	.15	.6	7.5	.6	7.4	.5
Building	.34	1.5	.6	.1	.9	.1
Progressive surtax	.42	1.8	18.9	1.6	28.8	2.1
Other	1.52	6.6	.5		2.1	.2
Total	6.44	27.8	150.8	12.5	188.7	13.7

	Fiscal year 1952-53		Fiscal year 1953-54		Fiscal year 1954-55		Fiscal year 1955-56	
	Billions of lire	Percent of total tax receipts	Billions of lire	Percent of total tax receipts	Billions of lire	Percent of total tax receipts	Billions of lire	Percent of total tax receipts
Ricchezza mobile	186.2	11.4	196.1	10.9	207.3	10.4	250.1	11.1
Corporation tax					59.5	3.0	57.0	2.6
Land	7.5	.5	6.9	.4	7.1	.4	6.7	.3
Building	1.5	.1	3.0	.2	3.6	.2	4.4	.2
Progressive surtax	28.5	1.7	27.7	1.5	32.7	1.6	38.1	1.7
Other	3.1	.2	2.9	.2	4.0	.2	3.8	.1
Total	226.8	13.9	236.6	13.2	314.2	15.8	360.1	16.0

[Enclosure No. 4]

Example of the direct tax burden on an Italian corporation located in Rome [1]

[Capital and reserves: 1 billion lire; data in lire]

Assessed income (corporation profit)	100,000,000
Income tax:	
Central government rate, 18 percent of assessed income	18,000,000
Provincial rate, 1.75 percent of assessed income	1,750,000
Communal rate, 3.50 percent of assessed income	3,500,000
Total	23,250,000
Corporation tax:	
On capital and reserves, 0.75 percent	7,500,000
On profits, 15 percent on 40,000,000 exceeding 6 percent of capital and reserves	6,000,000
	13,500,000
Total	36,750,000
Contribution to chamber of commerce, 0.75 percent of assessed income	750,000
Contribution to public assistance, 5 percent on central and local government income taxes	1,837,500
Additional Calabrian relief tax, 5 percent on central and local government income taxes	1,837,500
Total	4,425,000
Grand total	41,175,000

[1] Including the new corporation tax.

Example of the direct tax burden on an Italian corporation located in Rome—Continued

Collectors' fees, 4.75 percent on total tax collection (excluding corporation tax) (25,162,500)	1,955,812
Total direct tax (excluding tax on income from real estate, if any)	43,130,812
Total direct tax as percent of assessed income	43.1

[Enclosure No. 5]

Example of the direct tax burden on an Italian corporation located in Rome (without new corporation tax)[1]

[Capital and reserves: 1 billion lire; data in lire]

Assessed income (corporation profit)	100,000,000
Income tax:	
Central government rate, 18 percent of assessed income	18,000,000
Provincial rate, 1.75 percent of assessed income	1,750,000
Communal rate, 3.50 percent of assessed income	3,500,000
Total	23,250,000
Contribution to chamber of commerce, 0.75 percent of assessed income	750,000
Contribution to public assistance, 5 percent on central and local government income taxes	1,162,500
Additional Calabrian relief tax, 5 percent on central and local government income taxes	1,162,500
Total	3,075,000
Grand total	26,325,000
Collectors' fees, 4.75 percent on total tax collection (26,325,000)	1,247,317
Total direct tax (excluding tax on income from real estate, if any)	27,572,317
Total direct tax as percent of assessed income	27.6

[1] This hypothetical example, which excludes the 1954 corporation tax, is included here to illustrate the lower rate of tax incidence affecting corporations prior to the entry into effect of Law 603, August 6, 1954.

THE NETHERLANDS

CENTRAL BANKING IN THE NETHERLANDS*

1. Historical Setting

The Netherlands Bank was chartered as a joint-stock company in 1814 by decree of King William I, and its charter was continually renewed until the Bank was nationalized in 1948. Its original charter gave the Netherlands Bank a monopoly of note issue for 25 years, and the government subscribed to one million florins of its capital stock. The government disposed of its stock in 1847, and in 1863 the monopoly of note issue was formally withdrawn, but with each successive renewal of its charter, the Bank took on additional responsibilities as agent for the government. (The Netherlands Bank retained a *de facto* monopoly of note issue because the right was not given to any other institution.) Legislation of 1888 obligated the Bank to make limited advances to the government on current account, and also to turn over a share of its profits to the government.

From the beginning, the Netherlands Bank was authorized to conduct most ordinary banking operations both with private customers and other banks, but it was first permitted to buy and sell foreign bills in 1888, and domestic bankers' aceptances and Treasury paper in 1937.

2. Ownership and Control of the Central Banking Institution

The capital stock of the Netherlands Bank has been entirely owned by the state since nationalization of the Bank by the Act of April 23, 1948. The shareholders received government securities in exchange for their shares. All of the profits of the Bank are transferred to the government.

The Governing Board of the Netherlands Bank, which consists of the President, the Secretary, and from three to five Executive Directors, is appointed by the crown for a term of seven years and on the basis of nominations by a joint meeting of the Governing Board and the Board of Commissaries. The Board of Commissaries is appointed by the Minister of Finance, and consists of twelve numbers, each of whom serves a four-year term. The Board of Commissaries "supervises the administration of the Bank and approves and adopts the yearly profit and loss account."

3. Relationship of the Central Bank to the Government

The Finance Minister is empowered to issue directives to the Netherlands Bank, but the latter has the right to appeal to the crown in case of disagreement. Such an appeal would lead to a further careful

*Prepared at the request of the Joint Economic Committee by the Division of International Finance, Board of Governors of the Federal Reserve System, Washington, D. C.

consideration of the issue by the government as a whole. Traditionally, the Netherlands Bank does not support the government long-term bond market, although it is legally empowered to do so.

4. Relation of the Central Bank to the Commercial Banks

The Act on the Supervision of the Credit System, passed in January 1952, empowered the Netherlands Bank to issue "general instructions" to credit institutions concerning the maintenance of minimum reserves, maximum extension of credits, maximum size of individual credits, and prohibition or limitation of specific kinds of credits and investment, with the general exception that under no circumstances could a credit institution be compelled to hold Treasury paper. The Act also empowered the Bank to require credit institutions to submit periodic statements and such other information as the Bank should deem necessary. Before issuing an instruction the Bank must consult with the representative organizations of the credit institutions, and if their agreement is not obtained, the instruction in question becomes void unless it is approved by the legislature within three months of promulgation.

Since 1951, the discount rates of the Netherlands Bank have been higher for private customers than for banks, and this differentiation has tended to reduce the importance of the Bank's private business.

5. Power of the Central Bank Over the Instruments of Monetary Policy

Subject to the veto power of the Finance Minister and the machinery for appeal mentioned above, the Governing Board of the Bank has full power to set its discount rates and conduct open market operations. The Bank is empowered to buy and sell bills of exchange, and debenture bonds of the Netherlands government, or bonds guaranteed by it, provided such bonds are quoted on the Amsterdam Stock Exchange. In practice the maturities of securities traded in open-market operations have been from one to five years. Since open-market operations were begun in 1952, they have played a significant role in the monetary policy of the Netherlands Bank. For the most part, they have been used to offset changes in commercial bank liquidity arising from seasonal fluctuations and changes in the foreign balance, but in the first few months of 1956 open-market sales were undertaken with the object of exerting pressure on the money market.

The Netherlands Bank is empowered under the terms of the "gentlemen's agreement" of March 1954 to raise the cash reserve requirements of the commercial banks to 15 percent of total deposits; the ratio has been as low as 4 percent and as high as 10 percent. The Bank has the power, on a "stand-by" basis, to require minimum liquidity ratios of cash, call loans, and short-term securities to total deposits.

6. Channels or Sources Supplying Business Capital

In the postwar period two semi-public institutions have been established to provide long-term financing to business: the Reconstruction Bank (Maatschappij tot Financiering van het Herstel) and the Netherlands Participating Company. In general the Reconstruction Bank may not supply risk capital, but it may make loans involving more than normal risk if the loan carries a government guarantee. The Netherlands Bank hold fl. 3 million of preferred shares in the Reconstruction Bank, but its interest is small compared with that of the government proper, which hold fl. 168 million in stock out of a total capital of fl. 300 million. As its name implies, the Netherlands Participation Company invests in shares listed on the stock exchange or directly in participations. Over half of the stock of the Participation Company is owned by life insurance companies, pension funds and savings banks; nearly thirty percent of the stock is owned by the Reconstruction Bank.

The Netherlands Middle-class Bank (Nederlandsche Middenstandsbank), in addition to its principal business of granting commercial credit to small- and medium-class business, also makes loans for periods up to 10 years when these loans are guaranteed by the government. The Middle-class Bank is also a semi-governmental institution.

STRUCTURE OF THE NETHERLANDS CREDIT SYSTEM*

Practically all the *commercial banks* in the Netherlands belong to the Netherlands Bankers' Association, whose object is to further all banking interests and, specifically, to try to achieve uniformity in the charges imposed by its members. The commercial banks in the Netherlands are essentially concerned with short-term lending and do not receive savings deposits. At the end of 1955, out of their combined balance-sheet totals of some Fl. 8.3 milliard, sight and time deposits accounted for Fl. 4.2 and Fl. 1.7 milliard respectively, i. e. for Fl. 5.9 milliard in all. The "big five" account for some 70 per cent. of the total of the deposits and 65 per cent. of the loans and advances of all the commercial banks. About three-fifths of the total outstanding credit of the commercial banks is in respect of the public sector, the remaining two-fifths being loans and advances to the private economy. The bill of exchange has lost practically all its earlier importance in the Netherlands, owing to its fixed amount and term, notwithstanding the fairly low cost of borrowing in this way.

Three important groups of credit institutions collect savings: (i) *post office savings banks;* (ii) *general savings banks;* and (iii) *agricultural credit banks.* At the end of 1955 the savings appearing in the combined balance sheets of these three groups of institutions amounted to Fl. 1.7, 1.8 and 2.3 milliard respectively, making altogether Fl. 5.8 milliard, i. e. about the same amount as the total of sight and time deposits held by the commercial banks.

The general savings banks invest their funds to a large extent in readily marketable government securities and in loans extended to or guaranteed by public bodies. About 15 per cent. of their lending consists of mortgage loans. The agricultural credit banks use about 40 per cent. of the funds entrusted to them to make loans to farmers and farmers' organizations, either to provide them with working capital or—at medium and long term—for capital purposes, the remaining resources being invested in public-sector securities.

There are in the Netherlands over thirty *mortgage banks*, which obtain funds by the issue of mortgage bonds and by private loans (the amounts outstanding at the end of 1955 were Fl. 523 and 303 million respectively) and grant long-term mortgage loans, mostly on urban real estate (Fl. 906 million at the end of 1955).

Less important are the *popular credit banks*, the *building societies*, etc., notwithstanding the useful function which they perform for smaller borrowers. Worthy of mention also are a few semi-public institutions:

(i) The *Middenstandsbank*, which grants credits for limited amounts to retailers, artisans, etc., at short and medium term.

*Bank for International Settlements, Monetary and Economic Department, "Credit and Its Cost," (CB 268), Basle. Switzerland, January 1957.

(ii) The *Herstelbank*, a non-profit-making institution which lends to enterprises which do not have access to the capital market and wish to improve or add to their equipment. It also provides finance (through a specialized subsidiary) to the export trade.

Under the Bank Act of 1948 the *Nederlandsche Bank* was nationalised and given as its main function the task of regulating the value of the currency; the ultimate responsibility for monetary policy, however, rests with the government. There is also a Bank Council to advise the Finance Minister. The means which the central bank has at its disposal for the carrying-out of its duties are: (i) discount-rate policy; (ii) the use of open-market operations; (iii) the varying of the minimum cash-reserve balances required to be held by the banks, which are party to a gentleman's agreement with the central bank regarding cash reserves; the development of the foreign exchange reserve of the central bank is an important factor governing the use of this instrument; (iv) the power to introduce, if need be, credit ceilings, liquidity ratios or restrictions on certain kinds of credits.

There is in Amsterdam a *money market* which, while working more or less on the lines of the London money market, does not absolve the banks from having to apply directly to the central bank when in need of funds.

There is very little precise information available regarding the charges made by banks in the Netherlands. The official rates applied by the Nederlandsche Bank are as follows:

	Per cent.
For the discounting and rediscounting of bills of exchange	3¾
For advances to banks	4¼
For advances to private customers	5¼

The commercial banks pay 1 per cent. on demand deposits and 2 to 3¾ per cent. on time deposits; the savings banks pay between 2½ and 2¾ per cent. on time and savings deposits.

It can be estimated that the overall charges to the commercial banks' customers for advances and overdrafts vary between 5 and 7 per cent. Trade bills proper are discounted at a cost of 5 to 6 per cent. Medium-term loans—2 to 5 years—granted by the Herstelbank direct to industries for equipment purposes cost 5 to 6 per cent., while those granted by its specialised subsidiary for the financing of exports (Export Financierings Maatschappij) bear an overall charge of 6 to 8 per cent. The charge on ordinary mortgage loans is 4½ to 5¼ per cent., but mortgages on ships cost about 6 per cent.

Long-term yields show a very small spread, being in the region of 4¼ to 4¾ per cent. for government bonds and of 4½ to 5 per cent. for typical industrial bonds; taking account of the various issuing charges, borrowing in this latter form at long term costs between 5 and 5¾ per cent. Money-market rates in November 1956 averaged around 3 to 3¼ per cent. for call money. Three-month Treasury paper was quoted at about 3¼ per cent. and short-term loans up to six months were issued by local authorities at 5¼ per cent.

Netherlands: Main rates paid and charged by credit institutions (including commission, etc.)

[In percentages]

Items	Central bank	Commercial banks	Other credit institutions
Rates paid on—			
Sight deposits	-	1	-
Time deposits	-	2–3¾	-
Savings deposits	-	-	2½–2¾
Rates charged on—			
Trade bills (discounting)	3¾	5–6	-
Advances	4¼–5¼	5–7 (advances and overdrafts)	-
Overdrafts	-		-
Medium-term loans	-	-	5 –8
Mortgage loans	-	-	4½–6

METHOD OF MONETARY ANALYSIS USED BY DE NEDERLANDSCHE BANK*

M. W. Holtrop, President of De Nederlandsche Bank

Purpose of the method

The purpose of the method of monetary analysis which has been developed in the last few years in the Annual Report of the Nederlandsche Bank is essentially of a practical nature. It is meant to provide the Bank with a tool to help it in unraveling the mechanism of inflationary and deflationary disturbances and thus to aid the Bank in framing its policies.

I think that most of us will agree that it is one of the prime duties of central banks to prevent or at least to counteract—as far as is possible within the limits of their authority—any inflationary or deflationary developments of sufficient magnitude to create a threat to the long-run stability of the internal and external purchasing power of their monetary unit.

In order to be able to prevent or to counteract inflationary or deflationary developments, one must first be able to recognize them—and, if possible, to recognize them in their earliest stage. This may be done either by looking for the symptoms of their causes or for the symptoms of their effects.

Except in cases of gross monetary mismanagement, it has always been felt easier to recognize the effects of monetary disturbances than to clearly recognize their causes. We all agree that boom conditions, over-

*International Monetary Fund, "Staff Papers," February 1957, pages 303–306. (One of a series of papers presented at the 11th Annual Meeting of the Board of Governors of the International Monetary Fund, September 25, 1956.)

employment, increases in the price level, and balance of payments deficits —especially when showing up simultaneously—are indicators of internal inflationary disturbances, whilst underemployment, price falls, and balance of payments surpluses indicate deflationary conditions. Yet, when some of these symptoms contradict one another, we may feel less sure about the interpretation of our data, and even when agreeing about the observed effects we may find it difficult to agree upon their causes.

In the Netherlands, for example, the post factum analysis of the economic situation in 1953 led to very contradictory opinions about the monetary causes that had been at work. In the Annual Report of the Nederlandsche Bank, I myself concluded that a rather strong deflationary impulse emanating from the government sector had only partly been compensated by lesser inflationary pressures from the private sector, whilst their combined effect had been overcome by strong inflationary impulses from abroad, thus explaining the observed combination of mild boom conditions, increased employment, stable prices, and a rather big balance of payments surplus; however, Professor Witteveen, of the Rotterdam School of Economics, concluded on the basis of increased government expenditure and increased private investment that both government and the private sector of the economy had exerted a strong inflationary impulse, whilst the inflationary influences from abroad—judged by the increase in exports—had been rather negligible.

It is not difficult to imagine that the public showed itself rather flabbergasted by these contradictory opinions, and it took indeed some time before the core of the differences between the two authors had been thoroughly thrashed out in a very illuminating discussion, published in one of our leading economic periodicals.[1]

This discussion proved that, within the limits of their own definitions and methods of approach, both authors from a formal point of view had been right in their contradictory conclusions.

To understand how this was possible one must be conscious of the fact that any quantitative analysis of economic phenomena has to be based upon a set of simplified suppositions with regard to the interdependency of the different factors which are to be observed. This set of simplified suppositions is what economists nowadays call a "model." The simplification lies in the fact that on the basis of some presupposed rules of behavior—algebraically laid down in equations—a quantitative relationship between different phenomena is established. By considering only a limited number of factors to be open to "autonomous variations"

[1] See *Monetaire Uiteenzettingen* (Overdruk uit *Economisch-Statistische Berichten*, Rotterdam, 1956). See also H. C. Bos, *A Discussion on Methods of Monetary Analysis and Norms for Monetary Policy* (Netherlands Economic Institute, Rotterdam, 1956).

32061 O—59——15

and the others to be "dependent variables," one is able, with the help of such a model, to predict the probable consequences of assumed variations in the autonomous factors.

Also, post factum, one is able, by linking the observed variations in the dependent factors to the observed variations in the autonomous ones, to allocate the "causes" of the variations in the former, albeit that to explain the post factum quantitative relationships one may have to introduce also some "autonomous" changes in the actual rules of behavior compared with the assumed ones.

The fun, but also the trouble, of this method is that one is always technically right. Not of course in predicting the future, but always in explaining the past. It is for this reason that one should beware of the fact that a model is nothing but a piece of man-made machinery. One can never get out of it what substantially has not been put into it beforehand.

The post factum analysis can only show as "causes" the factors which have been introduced as "autonomous variables" when framing the model. If, post factum, the observed changes in the autonomous factors cannot fully explain, i.e., quantitatively do not fit in with, the observed changes in the dependent ones, such divergences simply have to be attributed to some "autonomous" change in the equations of behavior. Reality is always right. Any consistent model can technically explain everything. The point is whether the explanation has any relevancy.

These considerations prove the importance of choosing one's model, i.e., one's method of approach to a problem. My controversy with Professor Witteveen made it clear that by inflation and deflation he actually meant increase or decrease in national income. Consequently, he sought the ultimate causes of inflation and deflation in variations in a set of factors, which he considered to be the only autonomous determinants of changes in national income, viz., government expenditure, private investment, and changes in exports. These autonomous changes in expenditure are linked with their multiple effect on the national income by way of the income multiplier, a constant to be derived from the propensity to save, the propensity to import, and the rate of taxation.

Professor Witteveen's method of approach thus proved to be fundamentally of a nonmonetary nature. In the frame of his "model," monetary policy in the sense of banking policy and central bank policy cannot find any place whatsoever, the provision of finance to enable entrepreneurs to carry out their autonomous investment decisions, and to enable Government to carry out its expenditure decisions, being implicitly supposed to adapt itself to demand.

It is clear that such a model cannot fit the purposes of a central bank.

If one analyzes monetary phenomena with the purpose of getting some guidance for monetary policy, one must necessarily use a model in which monetary policy can find its place. If we believe that by monetary policy we can exert an influence on the creation of money, and maybe also on the propensity of the business community to hoard or to dishoard, and if we further believe that the exertion of such influence will affect the course of the inflationary or deflationary process, then, for the exposition of our ideas, we must choose a model in which the creation and cancellation of money and the acts of hoarding and dishoarding are treated as autonomous factors.

It is the purpose of the Bank's method to provide the data for such a model.

Background of the method

The line of thought on which the Nederlandsche Bank has based its analysis of monetary conditions starts from the proposition that the essence of monetary disturbances is to be found in the possibility, created by the use of money, of exercising effective purchasing power in excess of, or in deficiency of, current contribution to production. This can be done only by financing expenditure out of the creation of new money or by drawing on available liquid reserves, or, reversely, by hoarding money or taking it out of circulation. Such financing is, in the terminology of the Bank's Report, called an inflationary or deflationary method of finance.

Any inflationary monetary disturbance must be accompanied by money creation or dishoarding, i.e., by inflationary financing; any deflationary disturbance, by hoarding or cancellation of money, i.e., by deflationary financing.

It is important to see that this way of approach brings the problem of monetary disturbance back to the individual households.[2] Inflation is a problem of financing. It is the decision of individual households on how to finance their expenditure which is decisive for the occurrence or nonoccurrence of a monetary disturbance. In a closed economy, such initial disturbance is connected with its multiple effect on production, income, and prices by way of the monetary multiplier; in an open economy also, the balance of payment effects have to be taken into consideration.

From the monetary point of view, these acts of spontaneous inflationary or deflationary financing must be considered as final causes. Even if, from a more general point of view, we may conclude that they are not

[2] In economic literature in the Netherlands, the word "huishouding" is used with a wider connotation than is conveyed by the literal English translation, household. The word covers all the units by which economic decisions are made, and therefore includes not only family households, but also businesses, local authorities, and the Central Government.

quite autonomous, but that they themselves are motivated by other factors, we must consider them as final from the monetary point of view, because it is indeed the use of money that makes them possible and because it is our task as monetary authorities to concentrate on the problem of how to prevent, to restrain, to neutralize, to compensate, or, under certain very special circumstances, to stimulate them by the use of monetary policies.

Now we all know that, though banking statistics allow us to observe the sum total of the acts of creating and canceling money, we have no proper means of observing the acts of spontaneous hoarding and dishoarding. Worse still, even though, by observation of individual households, we may be able to observe spontaneous acts of hoarding and dishoarding, we may find it difficult to distinguish them from the acts of induced dishoarding and hoarding that are their necessary concomitants. As Robertson's famous dictum says: All money that is anywhere must be somewhere. Newly created money, once introduced into the income stream, must be held by some household. How can we distinguish this induced increased holding of money, which forms a reaction to the inflationary process, from the spontaneous hoarding that must be interpreted as a deflationary impulse?

The analysis of the Nederlandsche Bank is based on the contention that by applying certain techniques we can indeed, to a certain extent, do so.

Any act of inflationary financing—and in order not to make my argument too involved I shall now leave out the case of an act of deflationary financing, which leads, of course, to reversed consequences—as I say, any act of inflationary financing leads somewhere else to an increase in income—which may be either real or only nominal—or to a temporary disinvestment. Both will be accompanied by an act of hoarding. But the type of hoarding will be different in these two instances.

The act of hoarding that accompanies a temporary disinvestment which takes place in reaction to inflationary impulses elsewhere is nothing but the expression of a delaying factor in the inflationary process. There is no reason why in a free market economy this type of reaction should be lasting. After a short period of transition, normal dispositions will again prevail. For the time being, this reaction may indeed impede the observation of the forces that are at work and lead us to underestimate the strength of the inflationary impulses. If our observations relate to a sufficient lapse of time we may, however, safely ignore this temporary reaction, unless it be stimulated by the application of direct physical controls. In the latter case, it will lead to the phenomenon of "latent" inflation which we well remember from the strictly controlled economies of the war years.

The acts of hoarding—in the sense of increase of average cash balances held—that accompany any increase of income and turnover are of a different type. They result from the increase in the need of money for transaction purposes which is the necessary concomitant of any increase in the real or nominal level of income and turnover. It is this absorption of money in the transaction sphere which eventually sets a limit to and consolidates the effects of the original inflationary impulse. Any new income, by being spent, tends to create additional income and would continue to do so if the money, created or released by the original act of inflationary financing, were not gradually absorbed by the need for increased cash balances.

It is this absorptive reaction to the inflationary process which is the only lasting one and which has to be separated from the total of observable impulses in order to gauge properly the strength of the inflationary forces that are at work. Such separation can very well be based on circumstantial evidence. If we see that during a period of expanding production the business community has been heavily relying on credit expansion and has, moreover, been running down its holdings of near-money, such as treasury bills and long-term bank deposits, we need not feel any doubt that any observed increase in its cash balances is not due to any autonomous hoarding, but is to be interpreted as a reaction to the existing inflationary development. On the contrary, we may have every reason to believe that a certain amount of autonomous dishoarding of inactive money has been adding to the inflationary impulses and has contributed to increase the amount of active money now being absorbed by trade.

A further problem which arises when observing the financing dispositions of the individual households is the question of the exact definition to be given to the notions of hoarding and dishoarding.

As soon as we recognize that the original monetary disturbance consists of the withholding of purchasing power by an act of hoarding or, contrarily, by the exercise of purchasing power coming from resources other than current income, we have to make up our minds about the interpretation of transactions in the financial field. There are three possible courses of action.

In the first instance, one may interpret any act of saving, if it is also accompanied by simultaneous financial investment, as an act of hoarding, and any financing out of funds obtained from others as an act of dishoarding. This interpretation would force us to call any and all saving deflationary, and any investment, except out of own current income, inflationary. In my opinion this terminology would be grossly misleading. The transfer of funds by way of the capital market from a party who chooses not to invest in realities himself, to another party who does, is so much part and parcel of the normal flow of funds, and has so little to do with what we recognize as actual or potential monetary disturbance, that it would definitely be misleading to interpret such transfer as a deflationary activity on the part of the lender and an inflationary activity on the part of the borrower that happen to compensate one another.

A second possibility would be to reserve the notions of hoarding and dishoarding to hoarding and dishoarding of money itself. This would mean that any transfer of purchasing power by transactions in the financial field would be considered as indifferent from the monetary point of view. At first sight this solution would seem perfectly logical.

On second thought we find, however, that this method of interpretation would have many disadvantages by covering up financing dispositions, which are of essential importance in the analysis of inflationary and deflationary processes, and by forcing us to attribute different meanings to financing dispositions which in the eyes of the individual households themselves are perfectly equivalent.

The Nederlandsche Bank has therefore chosen a third possibility, by applying the notion of hoarding and dishoarding—and consequently the notions of deflationary and inflationary financing—not only to the act of hoarding and dishoarding of money itself, but also to the act of accumulating or running down liquid reserves in the form of certain types of near-money, the so-called secondary liquidities, i.e., short-term claims on the Government, local public authorities, and money-creating institutions.

Its reasons for doing so are the following: In the first instance, one must recognize that secondary liquidities, although they cannot directly be used as a means of payment, and therefore lack one essential function of money itself, are, for all practical purposes, equivalent to money in its function as a store of value. Consequently, there is not much sense in applying the notions of liquidity preference, of hoarding for reasons of the precautionary or the speculative motive, etc., exclusively to money itself. We are much nearer to reality, i.e., to the considerations that motivate the individual households, by applying these notions to the sum total of primary and secondary liquidities.

For a business concern of some magnitude, it is a matter of slight interest differentials whether to keep its liquid reserves in a current account balance, in a short-term bank deposit, or in treasury bills. If it decides not to reinvest for the time being the amounts accumulated on depreciation account—and that is one of the essential deflationary impulses that may originate in the private sector—then it may decide on either one or the other. On the other hand, it would not dream—at any rate not in the Netherlands—of investing its liquid reserve in bonds or in the stock market.

It is therefore quite proper to register the accumulation of money, of bank deposits, or of treasury bills as one and the same act of hoarding. Of course, if the accumulated treasury bills do not come out of the stock of treasury bills held by the banking system, in which case a clearly deflationary cancellation of money takes place, but are directly bought from the Treasury, and if the Treasury uses the money thus obtained for current expenditure, then indeed there need not be any net deflationary disturbance. In that case, however, it is much more illuminating, and therefore more relevant, to interpret this joint transaction as a deflationary development in the private sector, compensated by an inflationary development in the government sector, than to pass it over as a transaction that, from the monetary point of view, could be considered indifferent. For even if no actual monetary disturbance has taken place, a potential one has been created. When, some time later, the private sector decides to reinvest and forces the Treasury to repay its short-term debt, the Treasury in all likelihood will have to fall back on the banking system to meet its liabilities.

It is important to recognize that the impulse for this creation of money has originated in the private sector, even though we may find it necessary to insist that it is up to the Government to compensate this inflationary impulse by some deflationary financing of its own.

A second reason for the Nederlandsche Bank's extension of the notion of hoarding and dishoarding to secondary liquidities follows from the first. It is the fact that this interpretation allows a better, i.e., a more illuminating, allocation of the responsibility for inflationary and deflationary developments to the separate sectors of the economy.

A possible objection to the applied method is that, though it may be admitted that it is indeed difficult to draw a clear line of distinction between money and secondary liquidities, the same holds true for the distinction between the claims we do and those we do not include in the notion of secondary liquidity. Why, one might ask, include treasury bills in the first category but not short-term treasury bonds? The answer is that this objection is perfectly correct but that not too much importance should be attached to it. There generally are no sharp lines of distinction in practical life. Yet we have to draw them the best we can, the distinction of categories being an indispensable tool for any analytical thinking.

It may indeed very much depend upon local circumstances where the line has to be drawn between what is to be considered as secondary liquidity and what is not. The essential point is that only short-term debts of Government and money-creating institutions can properly be considered as falling in this category. For the essential difference between secondary liquidities and other relatively liquid claims is that the latter can be converted into actual money only by withdrawing purchasing power from the debtor or from some party who is willing to substitute himself for the creditor, whilst the owner of secondary liquidities can, for all practical purposes, force the debtor to create new money, because that debtor is either a money-creating institution, which has only to credit the owner of the claim on current account, or the Government, which would rather find some way to create new money than default on its debts.

Technique of the method

After these preliminaries about the basic ideas behind the method of analysis of the Nederlandsche Bank, the method itself is easily described. It consists of splitting the economy into separate sectors, so as to get as near as possible to what is happening in groups of individual households, and then to register the use of inflationary or deflationary methods of finance in each sector separately. Thus the Bank distinguishes (1) Central Government, (2) Local Authorities, (3) Institutional Investors and Miscellaneous Funds, (4) Capital Market and Sundry Items, and, finally, as a residual item (5) Private Individuals, Trade, and Industry. By using sample survey techniques, which the Nederlandsche Bank so far has not done, one might carry this sectional split still further, particularly for distinguishing between private households and entrepreneurs.

For each separate sector, the total amount of ascertainable net deflationary or inflationary financing is calculated. This total finds expression in the ascertainable liquidity surplus or liquidity deficit of the group. In a closed economy, the sum total of all liquidity surpluses and liquidity deficits must of necessity be zero. In an open economy, the sum total is equivalent to the national liquidity surplus or deficit, i.e., the balance of payments surplus or deficit. This surplus or deficit can again be interpreted as a deficit or surplus of a sixth sector of the economy, namely, the sector Foreign Countries.

Now, for most sectors, the ascertainable liquidity surplus or liquidity deficit can be taken as a direct measure of the net deflationary or inflationary impulse that has originated in that sector. For all practical purposes it is only in the sector Private Individuals, Trade, and Industry and in the sector Foreign Countries that the difficulty arises of properly distinguishing between financing dispositions that have to be interpreted as autonomous causes of the inflationary or deflationary processes and those dispositions that have to be interpreted as the unavoidable effects of such processes.

As I have explained before, it is—when observing a period of sufficient length—only the increase or decrease of cash holdings as a result of the transaction motive which has to be separated from the other acts of inflationary or deflationary finance and has to be interpreted as a reaction to, instead of as a cause of, the inflationary or deflationary process. Now, practically, we can say that this reaction will take place only in the sector Private Individuals, Trade, and Industry, where almost all the transaction money is being held. It is only in this sector, therefore, that the observed liquidity surplus or deficit has to be corrected for the likely change in transaction cash balances in order to arrive at an estimate of the net inflationary or deflationary impulses that have originated in this sector. Circumstantial evidence will easily give us a clue, if not to the exact magnitude, then at any rate to the direction of this reactive factor.

A second field in which we have to beware of the impulsive or reactive character of the observed liquidity surplus or deficit is in relation to foreign countries. The national liquidity surplus, i.e., the balance of payments surplus, can be just as well a reaction to the sum total of deflationary impulses that have been active internally as a measure of the inflationary impulses that have been working on the country from the outside. Here again, circumstantial evidence will have to help us in determining and interpreting the exact character of the observed facts.

The value of a scientific tool, such as an analytical method, can be judged only by the use that can be made of it. It is only when it helps us to understand better the relationship of things, to come to relevant conclusions about their interaction, and, if possible, to devise improved rules of conduct, that we have reason to prefer one method of description to another.

In this connection, it is important to know that the Nederlandsche Bank has not arrived at its method of analysis out of some theoretical deduction, but that this method has grown out of dissatisfaction with the results obtained from a previous analytical approach. This previous approach was the well-known technique of determining the causes of the changes in the volume of money from the combined balance sheet of the banking system. This technique was followed by the Bank up to 1950. But especially in the year of the Korea crisis with its terrific inflationary pressures, it proved itself quite inadequate both to explain clearly what was happening and to provide monetary policy with proper rules of conduct. It was therefore in 1951 that the Bank started with what is considered an improved analysis, which was then further developed in the ensuing years.

To give a simplified example of the type of situation with which the Netherlands was faced in 1950, let us assume that the analysis of the causes in the changes in the volume of money provides the following data for a certain period:

Government debt to banking system	+300
Private debt to banking system	+400
Net loss of foreign exchange	−1,000
Net change in monetary circulation	−300
Environmental conditions: a booming economy and rising prices	

A customary explanation of this situation would be to say that the increased indebtedness of the government and the private sectors to the banking system indicates inflationary conditions in both sectors. One might feel surprised at the combination of these inflationary conditions with a drop in the volume of money, but would probably be satisfied by explaining this drop as the effect of the large balance of payments deficit to which one would be apt to attribute an autonomous character.

The picture completely changes, however, when, after splitting the economy into sectors and taking into consideration the movement of secondary liquidities, we find that the Government has been repaying its floating debt to the private sector to an amount of 500 units—half to institutional investors and half to the rest of the private sector—and that both institutional investors and the rest of the private sector have been spending these funds on long-term investment and on real expenditure, whilst they have also been running down their cash balances for the same purposes.

It then becomes clear that the inflationary impulse has originated completely in the private sector, that the Government in its own sphere even had a liquidity surplus, which was, however, strongly overbalanced by the inflationary financing in the private sector, this latter being fed not only from credit expansion but also from the liquid reserves in the hands of entrepreneurs, the public, and institutional investors.

Further considering the necessary increase in cash balances for transaction purposes, which must necessarily have been connected with the increase in national income resulting from boom conditions and price increases, we would rightly conclude that the drop in total cash balances in the hands of the private sector was actually giving only a feeble expression to the magnitude of the inflationary impulse exerted by the financing of new expenditure out of available cash reserves.

This example will show why the Nederlandsche Bank believes that its method of analysis, even though it cannot claim to give an exact quantitative measure of the monetary impulses that are at work, yet enables one to obtain a better insight into their origin, their character, and their approximate magnitude.

Use of the method in monetary policy

As a guide to monetary policy, it is particularly important to recognize clearly the origin of both actual and potential monetary disturbances. Minding the old adage that prevention is better than cure, it must be considered the prime task of monetary policy, where possible, to prevent disturbances from arising at all. Trying to compensate for disturbances that have once developed is only a poor substitute for prevention. And yet, we have to be alive to the fact that some of the possible monetary impulses are definitely beyond the control of monetary policy. In this connection I feel that the method of the Nederlandsche Bank has the advantage over other types of analysis of better bringing home to us the enormous importance of the volume of liquid claims in the hands of the public.

Monetary policy, by the use of discount policy and other techniques, can exert a relatively strong influence on the volume of money newly created to finance new expenditure. It can exert no influence, or very little influence, on the recourse of the public to available cash reserves in the form of ready cash. Neither, however, can it exert any important influence on the recourse the public has to its reserve of secondary liquidities, and the less so, the shorter the average maturity thereof. It is almost impossible for the central bank not to accommodate the debtors of the secondary liquidities if they are faced with nonrenewal. No increase in the rate of discount can force them to default on their obligations. And the possible indirect ways of compensating an inflationary impulse which originates from a recourse to secondary liquidities are difficult to find and still more difficult to carry out.

There is much talk by economists about the compensatory anticyclical budget policies that governments ought to pursue. There is, alas, in practical politics very little to show in this field, especially in periods of inflationary boom.

These conditions may indicate that the fight against inflation has to be fought much earlier than we usually think. Much more attention may have to be given to the building up of the inflationary potential during periods of all-over monetary equilibrium by the too easy creation of secondary liquidities.

In an open economy, these conditions also have their consequences for the desirable level of foreign exchange reserves. These must be sufficient to carry the load of any irrepressible spontaneous internal inflationary development, including the possible recourse to secondary liquid resources. One of the practical applications of the use of its method of analysis in the field of monetary policy is to be found in some arrangements that exist between the Nederlandsche Bank and the Netherlands

Treasury. These arrangements are partly of a formal character and partly no more than a general understanding about some basic rules which the parties have accepted as a guidance for their policies.

Fundamentally, these arrangements are based upon the idea that indeed the liquidity surplus and the liquidity deficit of the Government, as defined by the Nederlandsche Bank, are proper measures of the deflationary or inflationary influence of government finance on the economy. As, generally, i.e., except under conditions of deflation, an inflationary influence of government finance should, of course, be avoided, the Treasury has on principle accepted the policy of not financing any expenditure by an increase of short-term debt, either in the hands of the banking system or in the hands of the public at large. On the other hand, the Nederlandsche Bank has recognized that the purpose for which the Treasury wishes to have recourse to the Bank is far more important than the fact that it should wish to do so at all. Consequently, the Bank has been willing on several occasions, e.g., in 1951, when the private sector of the economy fell back heavily on all available liquidities, to accommodate the Treasury by a direct purchase of treasury bills in order to enable it to repay short-term debt to the banks, but not to finance its own expenditure. Such recourse of the Treasury to the Bank has been called in the Bank's Annual Report a noninflationary recourse.

Also, in the conduct of its open market policy, in as far as the latter is based on the portfolio of treasury paper which the Bank obtained when the Government took over from the Bank the wartime Reichsmark claim of 4½ billion guilders, the Bank has been willing to agree to certain restrictions on its liberty of action and even to a formal obligation to accommodate the Treasury under certain circumstances, both, however, under the condition that the Government should not indulge in any inflationary financing in the aforementioned sense. In that case the Bank has regained its full liberty of action.

These examples illustrate that the analytical method we are discussing has been not only of theoretical use, but also positively helpful in coming to a sound and fruitful working relationship between the central bank and the Treasury.

The fundamental rules on which this working relationship is based follow directly from the underlying principles of the method of analysis that have just been set out. They might be summarized as follows:

(1) Borrowing by the Treasury from the central bank for the purpose of repaying debt to the banking system is by itself, i.e., apart from its indirect influence on bank liquidity, not of an inflationary character.

(2) Borrowing by the Treasury from the central bank for the purpose of repaying short-term debt to the public is by itself not of an inflationary character if the public entrusts these funds to the banking system.

(3) If, however, the public uses the released funds for financing new expenditure, such borrowing will indeed be indicative of an inflationary process. The origin of the inflationary impulse must then be attributed to the private sector of the economy.

(4) Borrowing by the Treasury from the commercial banking system for the purpose of financing expenditure has, by itself, exactly the same inflationary character as borrowing from the central bank.

(5) Borrowing by the Treasury from the public by issue of short-term debt for the purpose of financing expenditure can be actually, and is at least potentially, of an inflationary character. Such borrowing can fundamentally be justified only if serving to counteract the undesirable deflationary effects of spontaneous hoarding in the private sector of the economy.

Mr. Chairman, I am very grateful to you that you have taken the initiative for this panel discussion and that you have been so kind as to ask me to tell this illustrious gathering something about the methods the Nederlandsche Bank has been using to unravel the mystery of inflationary and deflationary developments. I do not claim that this method gives any final answer to the problem. I do believe, however, that it can be instrumental in attaining a better understanding of the strictly monetary aspects of the inflationary and deflationary process. Thus it may, perhaps, be helpful to both central banks and treasuries in better adapting their policies to fighting that curse of slow but persistent inflation that seems to be upon our present day world and to the lifting of which all our efforts should be dedicated.

TAXATION*

INCOME TAXES FOR INDIVIDUALS AND CORPORATIONS

The two most important Netherlands taxes are taxes on income—the income tax levied on the income of individuals, and the corporation tax levied on the income of corporations and/or companies.

The income tax is levied on income of residents of the Netherlands and of nonresidents who have sources of income within the country. The general rule is that the entire income of residents is subject to income tax, regardless of whether the income was earned within the country or abroad. However, nonresidents are subject to income tax only for that part of their net income which is derived from sources within the Netherlands. Whether a person is a resident of the Netherlands or not depends upon the length of his stay within the country, his intentions with regard to the length and nature of his stay, and similar factors.

"Net income" is considered to include the proceeds from enterprises owned by individuals or from work done in the Netherlands; from property in the Netherlands such as real estate; from claims secured by mortgages; from shares in bonds of Netherlands corporations which are domiciled in the Netherlands; from claims to recurring payments based upon public obligations, such as state pensions; etc.

The income tax is levied on a sliding scale. A married person with 2 children earning about $1,870 (7,200 guilders) annually would pay $156 in income tax. A person in the same category earning $13,000 would pay about $5,500 and a person earning $26,000 would pay about $13,700. If the net income exceeds $35,100 the tax would be $20,900 plus 70.5 percent of the excess over $35,100.

Wage and salary earners are subject to a withholding tax or wage tax. This tax is levied as an advance payment on the income tax. At the time of the final assessment the amount of wage tax withheld is deducted and, if this amount exceeds the income tax due, a refund is made.

Corporation Tax

Basis and rates.—A corporation tax is levied on the net profit (called "taxable amount") of Netherlands corporations and on the net profit of foreign corporations which operate in the Netherlands by means of a permanent establishment. The profits of the latter are taxed only to the extent they were made within the Netherlands.

Whether or not a corporation or a company is considered a resident corporation depends again on the particular circumstances. A corpo-

*Excerpt from United States Department of Commerce, Bureau of Foreign Commerce, "Establishing a Business in the Netherlands," World Trade Information Service, Part 1, No. 56-14 (February 1956).

ration incorporated under Netherlands law is always considered a resident corporation regardless of the nationality of the founders.

Taxable profits up to 40,000 guilders are subject to a tax rate of 40 percent; profits of 40,000 to 50,000 guilders, to 40 percent plus 15 persent of the amount above 40,000 guilders; and if the profits exceed 50,000 guilders, the tax rate is 43 percent on the excess.

Depreciation allowances.—In establishing the "taxable amount" for a corporation or company the cost price or the original purchase price of capital equipment may be written off. (However, writeoffs may not be based on replacement value.) A permanent method of depreciation writeoffs must be used, such as writing off a fixed percentage of the purchase value or the book value of the capital equipment.

In practice, the method of writing off a fixed percentage of the purchase value has been widely adopted. The annual depreciation percentage allowed for machinery is usually 10 percent.

Accelerated depreciation.—Corporations which have made investments in capital goods since January 1, 1950, may write off depreciation under an accelerated schedule. Ten percent of the original investment can be written off at the end of the first business year, plus the regular writeoff percentage, and the remaining value at the regular established rate of writeoff in subsequent years. In other words, new capital investments may be written off at a rate of 20 percent of the value during the first year and at the regular rate of 10 percent for the subsequent years.

This accelerated depreciation, however, is permissible only for new investments made through 1957 and is applicable to such general types of capital goods as machinery, office equipment, patents, and automobiles. Built-up property may not be depreciated at the accelerated rate except when it consists of entirely new factory buildings.

Deductions from profits.—Besides the provisions for depreciation and accelerated depreciation, Netherlands tax legislation provides for certain deductions from profits. Debts and manufacturing expenses incurred after April 1, 1953, may be deducted from the profit made during the year in which they were incurred at a rate of 4 percent of such debts or expenses, and for the next 4 years another 4 percent annually may be deducted from the annual profits so that a total of 20 percent of the purchase price or debt may be charged against the profits of a 5-year period.

The manufacturing expense or the debt must have been incurred for acquiring or improving equipment valued at 3,000 guilders or more. Industrial sites, residential dwellings, securities, and objects of small value are not considered eligible for this preferred tax treatment.

Inventory valuation.—Inventories may be valued at the actual cost of goods. However, if the market value on the date of the issuance of the balance sheet is lower than the original cost, this lower value may be taken. In certain instances the so-called "lifo" system may be used. Under this system the same valuation is applied at the end of the year as at the beginning, as respects an inventory of a permanent quantity of goods, with adjustments being made at the year end for the value of excess or reduced inventories.

A corporation or company is allowed to deduct from its profits shown in any given year losses sustained in the immediately preceding

6 years, insofar as such losses have not yet been applied to profits in 1 of the preceding years. Newly established firms are allowed, without a time limitation, to deduct from future profits losses sustained during the first 6 years until the total losses are compensated. For example, if a firm sustains a loss of 150,000 guilders during 1 year, but makes a profit of 20,000 guilders each in the subsequent 6 years, it may deduct 20,000 guilders from its annual profits during this period. Profits of later years cannot be compensated by the rest of the loss (30,000 guilders), except in the case of new establishments, which may carry forward such losses until they are completely compensated for by profits.

Other Taxes

Applicable in the Netherlands are a comparatively large number of other taxes and fees. Among those of importance to foreign investors is the "director's tax," which applies on the income from the directorship of a company and amounts to 50 percent of such income over $1,315. This tax is withheld by the company. The amount of income from a directorship after taxes is added to the other income of the director and is subject to the rates of the general income tax.

A "capital tax" applies on the value of net property. The rate is 0.5 percent of the value. Nonresidents are taxed only on their net property located in the Netherlands.

The "real estate tax" levied on owners of real estate in the Netherlands amounts to about 0.25 percent of the sales value of such property.

Sales or turnover taxes apply on domestic as well as on import transactions. The general rate is 5 percent ad valorem, but rates of 6 to 15 percent apply on a variety of commodities. This tax applies generally to the manufacturer or importer. Sales by retailers to the consumers are not subject to the sales tax.

Stamp duties or fees are levied in connection with the issuance of certain types of commercial paper, such as notes, insurance policies, and bills of lading. Registration fees apply on a number of transactions (issuance of shares, sales of real estate, etc.). Excise taxes are levied on a few basic commodities, such as sugar and tobacco products. Automobile taxes, as well as certain minor taxes imposed by the municipalities or Provinces, round out the Netherlands taxation picture.

SWEDEN

STRUCTURE OF THE SWEDISH CREDIT SYSTEM*

Historical Setting

The Sveriges Riksbank (National Bank of Sweden) was chartered as a private bank in 1656 and was the first note-issuing bank in Europe. It was reorganized in 1668 as a state-owned bank responsible to Parliament. Until 1830 the Riksbank carried on a largely commercial banking business while gradually developing the attributes of a central bank. From 1830 to 1897 other private banks were also given the note issue privilege. In that year, however, new legislation restored the note issue monopoly to the Riksbank and restricted its operations almost entirely to those of a central banking character.

Ownership, Control and Relationship to the Treasury

As indicated above, the Riksbank is state-owned. It is legally responsible to the Riksdag (Parliament), and operates under legislation which expressly prohibits Directors of the Bank from receiving instructions from anyone except the Riksdag and its Banking Committee. For example, the Finance Minister may meet with the Directors, but no decisions may be taken in his presence. The Chairman of the Board of Directors is the sole Cabinet appointee, while the other six Directors are chosen by the Riksdag. The chief executive, the Governor, is elected by the Directors from among themselves.

The independence of the Riksbank was seriously impaired during the 1930's, when the ruling Social Democrats subordinated monetary policy, then in disrepute, to the general economic policy of the Government. In the postwar period, when inflationary conditions prevailed, the Government continued to make cheap money an integral part of its policy of full employment and social welfare. Starting with Ivar Rooth in 1948, three successive Governors of the Riksbank are reported to have resigned in some part in protest against the monetary policy enforced by the Government.

Conflict between the central bank and the Government last broke out on July 11, 1957, when the Riksbank raised its discount rate from 4 to 5 per cent without informing the Government in advance. In retaliation, the Government forced the resignation of its appointee, the Chairman of the Board. The higher discount rate, however, was not subsequently altered by Parliament. The reduction in the discount rate from 5 to 4½ per cent on May 3, 1958, was apparently done with the full approval of the Government.

*Prepared at the request of the Joint Economic Committee by the Division of International Finance, Board of Governors of the Federal Reserve System, Washington, D. C.

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Instruments of Monetary Policy

In the postwar period Sweden has been beset by inflationary pressures, to which large Government deficits and a huge Government sponsored housing program have contributed. While the central bank has pegged the bond market during most of the period, it has done so at progressively higher interest rates since 1950, in order that the bonds necessary to finance housing and the Government deficit could be floated without a more excessive credit expansion than was already taking place.

Increasing reliance has been placed on monetary policy since 1950, and new instruments for control have been fashioned to meet changing financial conditions. The Riksbank has the authority to set minimum liquidity ratios as well as cash reserve requirements for the commercial banks, and these have been varied from time to time, usually with the cooperation of the commercial banks. Since 1952 the Riksbank has attempted to extend its control of commercial bank lending activities through the negotiation of voluntary selective credit restraints. In April 1955 liquidity ratios were raised to a new high and in September of that year the banks agreed to hold their advances below a specified level. Similar agreements were negotiated with savings banks and farmers' loan societies.

Government attempts to maintain low long-term interest rates for priority borrowers is reflected in control of all but certain specified new capital issues such as housing bonds. The Riksbank has reserved the right to decide on the terms and interest rates for nongovernment bonds and has in addition laid down guiding principles for the lending policies of banks and insurance companies.

Channels or Sources Supplying Business Capital

Traditionally the Swedish commercial banks have engaged in long-term financing of industry, although such loans are now limited to 10 years. In addition, they act as underwriters for bond issues and hold large portfolios of bonds and housing mortgages. In part this is due to the stability of bank deposits and the propensity of a large proportion of savings to be kept in the form of bank deposits.

The Ship Mortgage Bank is a semiofficial institution which grants long-term loans on the security of ship mortgages. In 1953 the commercial banks founded Svensk Fartygskredit AB for the purpose of financing loans to shipowners. The Industrial Credit Bank was organized in 1934 jointly by the Government and a few leading commercial banks for the purpose of giving medium- and long-term loans to industrial firms which were too small to have ready access to the bond market. The loans of this institution have never reached large proportions.

STRUCTURE OF THE SWEDISH CREDIT SYSTEM*

Essentially a bankers' bank, the *Sveriges Riksbank* is able to make use, in performing its function of regulating the supply and cost of money, of all the normal instruments of central-bank policy, i. e., changes in the discount rate, open-market operations and changes in cash-reserve requirements; it also makes recommendations to the banks, especially with regard to qualitative credit control and the observance of credit ceilings.

There are 15 *commercial banks* (with about 1,000 branches), the two largest (Svenska Handelsbanken and Skandinaviska Banken) accounting for over one-half of the total assets of the whole group. The commercial banks are subject to government control and to regulations regarding the size of savings deposits, liquidity ratios and the kind of assets in which their resources can or cannot be invested. In principle they grant only short-term loans, secured by some kind of collateral or—exceptionally—by a third-party guarantee. A typical feature is the predominance of savings and time deposits over demand deposits (less than one-fifth of the total deposits of the commerical banks are at sight). The main forms of lending are: the discounting of bills, the granting of advances on current account and in the form of overdrafts, and the granting of fixed loans. The latter form is almost as important by itself as the other two together.

The *savings banks* (of which there are some 450 in all) could up to the end of 1955 accept only savings deposits (usually of small and medium size), but since the beginning of 1956 they have also been legally authorized to open current accounts, subject to certain regulations. Their investments consist mainly of mortgage loans, ordinary advances and bonds. Savings are also collected by the *Post Office Savings Bank* and by the Co-operative Wholesale Society.

Sweden also has a great many specialised credit institutions, which are mainly concerned with mortgage lending. They are: the *city mortgage societies*, the *residential credit societies* and the *general mortgage societies*, all of which have their own central institutions for the raising of funds. The *agricultural credit associations*, which grant long-term credit to agriculture, also obtain their funds from a central organisation, the Agricultural Credit Bank. Medium and long-term credit on ships is supplied by the Ship Mortgage Association and the Svensk Fartygskredit.

There are also a few *government lending agencies* which supply funds (often supplementing credit granted by the credit institutions) for specific, socially useful purposes. Special mention should also be made of the "Postgiro" system, through which a large proportion of

*Bank for International Settlements, Monetary and Economic Department, "Credit and Its Cost" (CB 268), Basle, Switzerland, January 1957.

monetary transfers are effected (the turnover of this service in 1956 can be estimated at around S. Kr. 340 milliard).

The *Swedish Bankers' Association* represents the commercial banks, expressing their views to the government and the public and ensuring a certain uniformity in banking practice and (by means of special interbank agreements) in the terms and conditions applying to banking services. The savings banks have their own association.

Since November 23, 1956, when it was raised by 1/4 per cent., the official discount rate of the Riksbank has been 4 per cent.—the highest level since 1932. This rate is traditionally taken as the basis for establishing the rates for loans and deposits throughout the banking system.

It is worth mentioning that up to October 1950 the *rediscount rate* of the Riksbank, applied to first-class commercial bills rediscounted by the commercial banks, was 1/2 per cent. lower than the official discount rate. On that date the two rates were unified, but in June 1952 the Riksbank declared that it would in future apply a variable rediscount rate—independent of the official rate—with the object of preventing excessive rediscounting in periods of liquidity crisis. The variable rediscount-rate policy seems to have been in practice since the summer of 1955. The Riksbank at present charges the commercial banks 4 1/2 per cent. on loans for less than five days and 5 per cent. on loans for longer periods. 5 per cent. is, however, not a ceiling: if a bank were to have to borrow at the Riksbank for a considerable length of time, the interest rate could be raised step by step. In the course of 1956 the banks borrowed at the Riksbank only occasionally, in connection with end-of-month requirements.

The Swedish banks allow the following rates on the deposits which they receive from the public:

	Per cent.
(i) Sight deposits	0 –1 1/2
(ii) Time deposits	2 1/4–4 1/4
(iii) Savings deposits	3 3/4–4 1/4

The interest paid on short-term interbank loans during the latter part of 1956 stood mostly at 3 1/4 per cent. On the capital market the effective yield of government bonds in the middle of 1956 was around 4 1/2 per cent. The Swedish Government issued a 4 3/4 per cent. 24-year loan in November 1956 at par, and on 8th January 1957 a 5 1/4 per cent. bond loan, with an average currency period of 5 1/2 years, was floated at par by the "Fartygskredit AB".

As for the cost of credit to borrowers from the banks, the rate charged for advances on current account is normally 6 1/2 per cent. Fixed loans cost from 4 1/2 to 6 1/2 per cent. for the first three-month period, and thereafter—on renewal—an extra 1/2 per cent. is charged. The rate charged for the discounting of trade bills is from 4 1/2 to 7 per cent.

In the long-term sector first-mortgage loans cost 4.85 per cent. when they are irredeemable and otherwise 5 per cent. and second-mortgage loans cost 1/2 per cent. more, but when such loans are intended for housing purposes the borrower usually receives a government subsidy which reduces the cost to 3 and 3 1/2 per cent. respectively for first and second mortgages. Credits for the financing of building cost about 5 1/4 per cent. plus a fee of 1 per cent.

Main rates paid and charged by credit institutions (including commission, etc.)

[In percentages]

Items	Central bank	Commercial banks	Other credit institutions
Rates paid on—			
Sight deposits		0–1½	
Time and savings deposits		2¼–4¼	4
Rates charged on—			
Trade bills (discounting)	4	4½–7	
Loans and overdrafts		4½–7	
Mortgage loans			4.85–5.00

TAX PRIVILEGES*

Savings deposits within certain fixed limits are exempt from income tax and property tax. Life assurance premiums amounting to not more than S.Kr. 300 for a single person or S.Kr. 600 for a married couple may be deducted from the taxable income.

For income tax purposes, taxpayers are allowed to deduct from their income from invested savings a fixed amount, which, for a married couple, is S.Kr. 600. This deduction is, of course, quite distinct from that authorised for life assurance premiums. Special tax privileges are also attached to the premium savings scheme described below.

SAVINGS INSTITUTIONS

Steps have been taken to facilitate the functioning of the savings banks. For instance, regulations introduced at the beginning of 1956 have enabled savings banks to extend the field of their activities. Inter alia, these banks have been authorised to open cheque accounts, and this may enable them to attract new customers.

Shareholders' clubs, similar to the Canadian investment clubs, have also been created recently, under the sponsorship of some important commercial banks. Members of such clubs are generally asked to pay regular monthly contributions, the funds thus collected being invested in equities.

SAVINGS MEDIA

The advisability of index-tied loans or deposits is the subject of much controversy in Sweden. One such loan is, however, already in operation. It was issued in 1952 by the Kooperativa Förbundet and provides for compensation to the extent of 50 per cent. for losses suffered through a rise in the cost of living.

There is one example of a loan with no fixed interest, issued by the Savings Banks' Real Estate Institute. The rate of interest is fixed at 0.15 per cent. less than the rate charged by the savings banks themselves on real estate loans.

*Balance of text from Bank for International Settlements, Monetary and Economic Department, "Personal Saving and Its Promotion" (CB 290), Basle, Switzerland, April 1958.

A lottery savings scheme for young wage-earners has been in operation since 1949. To participate in this scheme, savers must undertake to pay regular monthly contributions amounting to at least 10 per cent. of their wages. The savings are deposited in special accounts where, as a rule, they are locked up for three years, the government contributing funds for a lottery in the drawings of which the depositors participate gratuitously.

PREMIUM SAVINGS SCHEME

The government introduced, in May 1955, a premium scheme to stimulate voluntary savings. Taxpayers with a taxable income of at least S.Kr. 1,200 per annum were able to participate in the scheme, which operated in 1955 and 1956 only. The maximum deposit was S.Kr. 1,000 per annum and per individual. The minimum amount which could be deposited at any time was S.Kr. 10. Interest is paid at the rate of 4 per cent. In addition to the interest there is a premium amounting to 20 per cent. on deposits made in 1955 and to 15 per cent. on deposits made in 1956, but this is payable only in respect of amounts held on deposit until 1961. The premium will be paid in cash and is tax-free. As the object of this measure was to raise additional savings, payment of the premium has been made subject to the condition that the deposits were not made up of amounts merely transferred from another account or obtained through the sale of securities or the cancellation of a life assurance contract. The tax authorities verify, on the basis of income returns, whether this condition has been satisfied. Furthermore, each participant had to complete a special form enumerating his assets. At the end of 1956 some 600,000 accounts, totalling S.Kr. 720 million, had been opened. The premiums on these will cost the government S.Kr. 125 million. Deemed to be too expensive, the scheme was abandoned in 1956 and was replaced by an increase in the deductions allowed to be made, for tax purposes, in respect of proceeds from saved income.

TAXATION*

Income taxes in Sweden are collected at the source. These are preliminary taxes which must ordinarily be paid during the year in which the income is received. A final assessment is made during the year following the income year and this is used as the basis for computing the final tax.

Taxes Payable by Individuals

Individuals in Sweden are subject to the following personal taxes: Local (municipal) income tax; local real estate tax; national income tax; and national capital assets tax. In Sweden the Central Government collects both national and local taxes. Local income tax payments are then allocated to the municipality, province, and parish in which the taxpayer resides.

Every person earning an annual income of 1,200 crowns or owning capital assets valued at 50,000 crowns (1 crown equals US$0.193) is required to submit an annual tax declaration each February which states his income for the preceding year and the amount of capital assets at the end of that year. The tax year covers the period January 1–December 31.

Local income tax.—Income for local income tax purposes is defined as income from all income sources. Income from employment includes deferred income payments such as pensions and annuities, while capital income is classed as interest, dividends, income from business activity, and income from land and houses.

Capital gains on securities and other capital assets owned by a taxpayer are classified as income according to the length of time the taxpayer owns them. The amount of the gain taxable varies from 100 percent for assets owned 2 years or less to 25 percent for assets held for 4 years but less than 5. Capital gains on securities and other capital assets owned for more than 5 years are not subject to taxation.

Capital gains derived from the sale of real estate also is subject to a tax based on period of ownership. All of capital gains from property held less than 7 years is subject to full taxation, with the percent of gain taxable then decreasing to 25 for property held for 9 years but less than 10 years. Capital gains from the sale of property held over 10 years is not subject to the income tax.

A Swedish taxpayer is permitted certain general deductions from net income from all sources. Among these deductions are periodic contributions to dependents, premiums paid for annuities, pensions, and life insurance, and losses as defined in the tax code. The maximum deduction allowed for life insurance premiums is 200 crowns for a single person and 400 crowns for a married couple. A wife who is gainfully employed may deduct 300 crowns from her income.

*Excerpt from U. S. Department of Commerce, Bureau of Foreign Commerce, "Establishing a Business in Sweden," World Trade Information Service, pt. 1, No. 55–6 (January 1955).

The amount remaining after all such deductions is the taxpayer's total assessed income.

In addition, a taxpayer is given a personal or family exemption which is deductible from the assessed income. The amount of exemption varies according to the cost-of-living area in which the taxpayer resides. There are four different areas, with Stockholm classified as the highest cost-of-living area in the country. The exemptions by area are:

[In crowns]

Cost-of-living area	Exemption for single person	Exemption for family
II	1,230	1,760
III	1,290	1,840
IV	1,340	1,920
V (Stockholm)	1,400	2,000

Subtraction of the above exemptions from the assessed income gives the taxpayer's taxable income.

Local income taxes are not progressive. Tax rates vary considerably in the different municipalities, provinces, and parishes. In Stockholm, for example, the local tax rates total about 10½ percent of taxable income. The national average for local tax rates is about 12 percent of taxable income.

REAL ESTATE TAXES

An assessment is made of real property in Sweden once every 5 years. The assessed value for tax purposes is in principle the current market value of the property, but in practice it is generally somewhat lower. The real estate tax is an annual tax based on an amount equal to 4 percent of the assessed value. The rate of the tax on real property is always the same as the local tax rate on income.

The taxpayer in making his local income tax return is allowed to reduce income derived from real estate by 4 percent of the assessed value of the property.

NATIONAL INCOME TAX

Total net income for national income tax purposes is determined prior to deductions and personal exemptions in the same manner as for the local (municipal) income tax.

A Swedish taxpayer is permitted to make the same general deductions in preparing his national income tax return as for the local income tax return. However, in addition the taxpayer preparing a national income tax return may also deduct from income the amount of the local income and real estate taxes paid in the preceding year. A gainfully employed wife with one or more children under 16 years of age may deduct, in addition to the 300 crowns permitted for local income tax purposes, 10 percent of her income up to a maximum deduction of 1,000 crowns (the 300-crown deduction is included in this maximum sum).

The personal exemption for national income tax purposes by cost-of-living areas is as follows:

[In crowns]

Cost-of-living area	Exemption for single person	Exemption for family
II	1,760	3,520
III	1,840	3,680
IV	1,920	3,840
V (Stockholm)	2,000	4,000

Subtraction of the above exemptions from the assessed income gives the taxpayer's taxable income.

Husbands and wives who have separate incomes must submit separate returns. In determining their taxable income the family exemption is divided equally between them. The amount of the tax is then calculated on the combined taxable incomes of husband and wife, this amount being apportioned between them on the basis of the amounts of their taxable income.

The Swedish Riksdag fixes annually the tax rate for national income tax purposes. This tax rate is progressive in character. Tables 1 and 2 show the tax rates for the income years 1954 and 1955.

TABLE 1.—*National income tax table for a family*

Taxable income (in crowns)		National income tax
Over—	Not over—	
	8,000	At rate of 13.2 percent.
8,000	10,000	1,056 crowns plus 17.6 percent of excess over 8,000 crowns.
10,000	12,000	1,408 crowns plus 22 percent of excess over 10,000 crowns.
12,000	16,000	1,848 crowns plus 27.5 percent of excess over 12,000 crowns.
16,000	20,000	2,948 crowns plus 33 percent of excess over 16,000 crowns.
20,000	30,000	4,268 crowns plus 38.5 percent of excess over 20,000 crowns.
30,000	40,000	8,118 crowns plus 44 percent of excess over 30,000 crowns.
40,000	60,000	12,518 crowns plus 49.5 percent of excess over 40,000 crowns.
60,000	100,000	22,418 crowns plus 55 percent of excess over 60,000 crowns.
100,000	150,000	44,418 crowns plus 60.5 percent of excess over 100,000 crowns.
150,000	200,000	74,668 crowns plus 65 percent of excess over 150,000 crowns.
200,000		107,168 crowns plus 65 percent of excess over 200,000 crowns.

TABLE 2.—*National income tax table for a single person*

Taxable income (in crowns)		National income tax
Over—	Not over—	
	4,000	At rate of 13 2 percent.
4,000	6,000	528 crowns plus 17.6 percent of excess over 4,000 crowns.
6,000	8,000	880 crowns plus 22 percent of excess over 6,000 crowns.
8,000	10,000	1,320 crowns plus 26.4 percent of excess over 8,000 crowns.
10,000	12,000	1,848 crowns plus 29.7 percent of excess over 10,000 crowns.
12,000	16,000	2,442 crowns plus 33 percent of excess over 12,000 crowns.
16,000	20,000	3,762 crowns plus 37.4 percent of excess over 16,000 crowns.
20,000	30,000	5,258 crowns plus 41.8 percent of excess over 20,000 crowns.
30,000	40,000	9,438 crowns plus 46.2 percent of excess over 30,000 crowns.
40,000	60,000	14,058 crowns plus 50.6 percent of excess over 40,000 crowns.
60,000	100,000	24,178 crowns plus 55 percent of excess over 60,000 crowns.
100,000	150,000	46,178 crowns plus 60.5 percent of excess over 100,000 crowns.
150,000	200,000	76,428 crowns plus 65 percent of excess over 150,000 crowns.
200,000		108,928 crowns plus 65 percent of excess over 200,000 crowns.

NATIONAL CAPITAL ASSETS TAX

A person owning capital assets in excess of 50,000 crowns is required to pay a special property tax. This tax is in addition to any tax on income derived from these assets.

The net amount of capital assets owned by a taxpayer is subject to the capital assets tax after deductions have been made for all debts. Taxable property includes virtually every kind of asset—land, buildings at their assessed value, securities of all kinds according to their market value at the end of the tax year, bank deposits, personal property (including jewelry, automobiles, and yachts)—according to their current depreciated value. Furniture and other articles used by the taxpayer or his family, private art collections, and books are not subject to this tax.

Assets belonging to a person who has not become of age (21 years), living with his parents and not subject to the national income tax, are considered for capital assets tax purposes as property of the parents. The national capital assets tax for a husband and wife is assessed on their combined property. Table 3 shows the rates of the capital assets tax.

TABLE 3.—*Capital-assets tax table*

Property value (in crowns):	*Capital assets tax*
50,000	0 plus 0.5 percent of excess over 50,000 crowns.
100,000	250 crowns plus 0.8 percent of excess over 100,000 crowns but not over 150,000 crowns.
150,000	650 crowns plus 1 percent of excess over 150,000 crowns but not over 200,000 crowns.
200,000	1,150 crowns plus 1.3 percent of excess over 200,000 crowns but not over 400,000 crowns.
400,000	3,750 crowns plus 1.6 percent of excess over 400,000 crowns but not over 1,000,000 crowns.
1,000,000	13,350 crowns plus 1.8 percent of excess over 1,000,000 crowns.

A special reduction clause affords some relief for taxpayers with large capital assets but small incomes. If the total assessed income from all sources is less than 3⅓ percent of the capital assets, then the capital assets tax is not levied on that part of the assets which is more than 30 times as large as the total assessed income from all sources. The taxable amount of a taxpayer's capital assets may not, however, be reduced to less than one-half of his total assets.

Swedish tax laws provide that total taxes due for a given period may not exceed 80 percent of a taxpayer's net income for that period, before direct taxes.

TAXES ON CORPORATIONS AND OTHER GROUPS

Joint-stock companies are subject to the same local (municipal) income and real estate taxes as are individuals but are not granted the personal or family exemptions. The local tax rates are also the same.

The national income tax rate for joint-stock companies is fixed at 40 percent of annual net profits after deduction of local income tax payments. Corporations are not subject to the national capital assets tax.

The profits of Swedish joint-stock companies are subject to double taxation. Companies must, first of all, pay the local income tax on their taxable profits. This tax averages about 12 percent. After deducting this tax from taxable profits they pay the national income tax on the remaining profits. Together these taxes average about 47 percent of the profits. Second, the stockholders have to pay local and national income taxes on the dividends received as well as a national capital assets tax on the value of the shares owned.

Since 1952, a temporary law (continued in effect during 1955 for tax year 1954) has limited the depreciation allowances on new machinery and equipment acquired by corporations to 20 percent per annum, whereas assets acquired before 1952 can still be written off freely. The right to make deductions from taxable income for depreciation on buildings and other real property is as a rule strictly limited to certain percentages laid down by law. For industrial buildings an annual deduction of 3 percent of the original cost is generally allowed. Private firms and partnerships are restricted to certain maximum annual depreciation rates which are somewhat different from those allowed corporations (e. g., 10 percent of the original cost of machinery; 20 to 25 percent for motor vehicles).

Economic associations such as cooperatives, savings banks, mortgage and building and loan companies are, among others, subject to a national tax rate of 32 percent. Life insurance companies pay a national income tax of 10 percent on their net profits. Nonprofit organizations are subject to a tax of 15 percent on their net profits.

These taxpayers pay local taxes at the same rates as the individual taxpayer and the joint-stock company. Most of the above types of taxpayer do not have to pay a tax on their capital assets. Organizations whose members have no claim on the organization's capital assets are, however, subject to a tax of 1½ percent on total assets exceeding 5,000 crowns.

Miscellaneous Taxes

Among the other taxes collected by Sweden are estate taxes; inheritance taxes; gift taxes; a coffee tax; excise taxes on spirits, beer, malt, mineral water, carbonated beverages; a stamp tax on playing cards; a consumption tax on gasoline and various temporary taxes on agricultural products and their derivatives; a tax on automobiles; and luxury taxes on specified commodities (confectionery, dentifrices, cosmetics, furs, gold, silver, and platinum ware, and jewelry).

Tax Liability of Foreigners

Any person owning real estate in Sweden is subject to the local real estate tax regulations, regardless of whether or not he resides in Sweden.

Persons resident in Sweden at the end of an income year are required to pay a capital assets tax on all property owned in Sweden and abroad. If a person is not a legal resident of Sweden at the end of the income year he is subject to capital assets taxes on only the following capital assets: (1) Swedish real estate, (2) assets in Sweden which are part of enterprises carried on in Sweden, (3) ownership equity in Swedish economic associations and joint-stock company shares, if shares are held in a business carried on in Sweden by the taxpayer. Nonresidents of Sweden are subject to a special coupon tax on dividends on shares which is deducted at the source. This coupon tax is 10 percent for persons legally residing in the United States and certain other countries, otherwise the tax rate is 20 percent.

The income tax is, in principle, levied on the income of all persons resident in Sweden regardless of nationality. The tax is levied on all income irrespective of source.

American citizens are eligible for the benefits afforded under a convention for the avoidance of double taxation concluded between the United States and Sweden in 1939. The provisions of this treaty which are reciprocal are applicable to individuals, corporations, and other entities. In general, Americans resident in Sweden are subject to Swedish taxes on income from labor and services performed in Sweden. Income of commercial enterprises taxed by one state is exempt from taxation in the other. Income from real property is taxable in the state in which the property is located.

Overhead Costs

Gas and electric rates in Sweden are uniformly low. The domestic and international telephone, telegraph, and postal services are excellent. A fee of 200 crowns is charged for a new telephone installation. The service charge is 27.50 crowns per quarter for each apparatus in use plus a charge of 0.06 crown for each call made (this applies to the Stockholm district). The rates for long-distance calls are moderate. Nearly 2 million telephones are reported in operation in Sweden.

Rental of office space has been a serious problem in most cities in Sweden because the construction of office buildings has been limited since World War II. Floor space is rented by the square meter. The rates vary depending on the type of building. Floor space in older buildings rents for about 50 crowns per square meter.

Items of equipment, such as desks, safes, stationery, and supplies of all kinds, are available at reasonable prices.

(Based on reports from the American Embassy, Stockholm, and on Swedish official documents and commercial reports; prepared for publication in the European Division, Office of Economic Affairs.)

January 1955.

INDUSTRY TO HAVE GREATER ACCESS TO INVESTMENT FUNDS*

Summary

A more liberal policy toward the use of "investment funds for business cycle equalization purposes" has recently been adopted by the Labor Market Board, the responsible administrative agency. Provision for the establishment of these funds, which amounted to 650 million kronor [1] at the end of 1957, was made in 1938; the Government's objective was to smooth out business cycle fluctuations by encouraging the establishment of such funds, to be released or frozen in an attempt to counter either recessionary or inflationary forces.

Although the Labor Market Board has in the past been quite restrictive in granting a firm the necessary permission to use its investment fund, the Board announced recently that companies would be allowed to use their investment funds on projects which would create employment. Approval by the Labor Market Board would still be required however.

Background

Since 1938, Swedish corporations and economic associations (cooperatives) have been able to reduce their taxable profits by allocating a share of the profits to equalization investment funds. The most recent changes in these regulations, made in 1955, provide that up to 40 percent of net profits before taxes may be placed in an investment fund; this amount may be deducted from gross income in preparing tax returns on the condition that 40 percent of the fund be placed in a non-interest bearing account in the *Riksbank*. No part of the fund may be used by the company within the first five years without authorization from the Labor Market Board. After five years, the company has the right to use up to 30 percent of the amount which has been deposited at the *Riksbank* plus its self-held funds so long as the total amount does not exceed 30 percent. For example, if a company decides to set aside 10,000 kronor in an investment fund, it must deposit 4,000 kronor in the *Riksbank* in order to qualify for the 10,000 kronor deduction from taxable income. After five years, the company may withdraw for investment purposes 1,200 kronor from the *Riksbank* account and 1,800 kronor from its self-held investment fund. Authorization to use the balance of the fund must be obtained from the Labor Market Board which makes its determination on the basis of whether the proposed investment is "productive" and on employment conditions prevailing at the time. If a company uses its investment fund (by using the *Riksbank* deposit or its self-held fund) without authorization or for purposes other than those stipulated by the Board, the amount is taxed as income in the year in which it is used and is also

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*An unclassified Foreign Service despatch prepared by the American Embassy, Stockholm, June 6, 1958.

[1] One krona = $0.193.

subject to a penalty tax payment on 10 percent of the amount used without authorization.

Current Developments

It is only since 1955 that corporations have shown much interest in these investment funds. Prior to that time, depreciation allowances were considered so liberal that companies preferred to sacrifice the income tax deductions available in connection with the investment fund in order to maintain control over their investments. But, since the tightening of depreciation allowances in 1955, the tax-reduction feature of the investment fund has become increasingly attractive. These funds have grown from about 250 million kronor at the beginning of 1955 to 414 million kronor and 539 million kronor at the beginning of 1956 and 1957, respectively. They reached 650 million kronor at the close of 1957.

In 1957, 16 applications were made for permission to use the funds but only one application was approved. Five of the applicants went ahead without the permission of the Labor Market Board and used part of their funds, in an amount totalling 800,000 kronor. This amount plus a 10 percent tax penalty accordingly became taxable.

On May 28, 1958, the Labor Market Board announced that it had approved three applications, the funds to be used during fiscal 1959. The approved projects were as follows:

Uddeholms AB: 1,450,000 kronor for replacement of the groundwood mill on the Göta river, destroyed in a landslide last summer.

Sandviken Iron mills: 2,700,000 kronor for expansion of a carbide metal plant at Sandviken.

Boxholm AB: 280,000 kronor for modernization of an ore sintering plant at Sköldinge.

Despite the less restrictive attitude of the Labor Market Board, the Federation of Swedish Industries contends that a further liberalization is in order. The Federation recommends that, under present circumstances, a general license should be granted at least for the use of the 247 million Kronor which had been placed in these funds before 1955. The Federation contends that this money is needed by industry to enable it to keep pace with technical advances and to make the adjustments which a Free Trade Area would necessitate. In commenting on these views, Finance Minister STRÄNG denied the usefulness of a general license. Such a procedure would, he said, divert investment money to industries which are merely short of labor as well as to those with unemployment.

The Embassy considers it unlikely that the criteria for granting permission to use investment funds will be broadened appreciably. But in any case, this year's excess of unemployment compared with last year makes it rather likely that an increasing number of firms will be eligible to draw on their investment funds without suffering tax penalties. Despite recessive trends in Sweden and abroad, private investment should receive some stimulus from the somewhat freer availability of these funds in conjunction with the easing of other investment restrictions. These include, for example, removal of the investment tax, easing of licensing restrictions on nonresidential construction, lowering of the discount rate and some easing of credit controls.

TAX POLICY AND BUSINESS FIRMS' INVESTMENT ACTIVITIES*

Prof. Nils Västhagen, the Stockholm School of Economics

The Structure and Aim of the Taxation of Business Profits

In 1955 the taxation of Swedish business firms was amended in various respects. Most of the amendments were made on the recommendation of the Business Profits Taxation Committee, which in 1952 had been given the task of revising the rules governing the taxation of business firms' incomes. These amendments were concerned with write-offs on machinery and equipment, stock valuation, allocations to investment reserves and allocations to pension and other staff foundation reserves.

In regard to *machinery and equipment*, corporations and certain other juristic persons had been entitled during the period 1938—1951 to write off at their discretion. This right implied that the cost value could be written off at such pace as the firm itself desired; in fact, the entire cost value could be written off in the first year. A precondition for free writing-off for tax purposes was that the same write-offs were shown in the accounts. After some provisional restrictions in 1952—54 new and permanent rules were embodied in the tax laws in 1955. Free writing-off was replaced by "*writing-off according to the books*", which may be applied by all firms with an organized system of double entry—that is to say, not only by corporations and juristic persons of a kindred type. The most important rules governing this writing-off system are as follows:

The main rule is based on the degressive writing-off principle. On machinery procured during the year 30% may be written off and likewise 30% may be written off on older machinery, the write-off being calculated on the book value. The amount written off for tax assessment purposes shall in this system tally with that written off in the accounts, as the term indicates.

If machines procured before the beginning of the income year have been sold during the year, the "net method" may be applied. The entire proceeds of the sale are declared for tax purposes, but a corresponding amount may be utilized for extra write-offs on existing machinery (which, however, may not be written off at a negative value). The basis of calculation for the 30 percent. write-off shall be correspondingly lower.

According to the main rule, it is never possible to come down to nil unless in any particular year the proceeds of the sale are exceptionally high (at least as high as the balance brought forward plus renewals). In order to make this possible a supplementary rule has been introduced to the effect that the machinery *in toto* need not be

*Skandinaviska Banken Quarterly Review, vol. 38, No. 3, July 1957, pp. 62–73.

given a higher value than if it had been written off each year at 20% of its cost value. Only machines existing at the end of the year are included in this calculation.

For income tax purposes there formerly existed a right to a more or less free *stock valuation*. Only in a few cases did the Tax Authorities intervene against any radical writing-down of stocks. The 1955 rules are to the following effect:

The main rule lays down that the stocks may be kept written down to 40% of their current value after deduction for obsolescence. By their current value is meant either their cost value or their replacement value, whichever is the lower, the cost value being calculated on the principle of "first in—first out". During the transitional years 1956—1958 the stocks may be written down to 20% (1956) and 30% (1957 and 1958).

In the event of a reduction in stocks, supplementary rule 1 may be applied, according to which the 60 per cent. write-down may be computed on the mean between the two immediately preceding years' stock values. The secret reserve calculated in this way may be deducted from the value of the current stocks. Even a negative stock value is accepted.

In regard to raw materials and staple goods, supplementary rule 2 is applicable. According to this rule, for the purpose of stock valuation the lowest market quotation during the past 10 years may serve as basis of calculation and the stocks may be written down to 70% of the resultant value.

An allocation to an *investment reserve* may be made annually at not more than 40% of the profit before tax. The allocation is deductible in the income tax return. 40% of the allocation to reserve shall be paid in to the Riksbank for deposit on a special account.

An investment reserve may, with the permission of or by the order of the Labour Market Board, be utilized mainly for the following purposes:

(a) for writing-off on a building erected during the year (in regard to industrial firms for repairs as well),

(b) for writing-off on machinery and equipment procured during the year,

(c) for writing-down commodity stocks (though not to a lower amount than is allowed by the stock valuation rules),

(d) for costs connected with certain operations in mines.

When an investment reserve is utilized, then 40% of the amount by which the reserve is reduced may be withdrawn from the account in the Riksbank. After 5 years 30% of the amount paid in may be withdrawn without a special permit, and the reserve shall then be reduced by 2½ times the amount withdrawn. A special "investment deduction" is allowed at 10% of the amount utilized out of the reserve subject to permission (or an order) given by the Labour Market Board. If the reserve has been utilized in contravention of the regulations, the amount shall be subject to tax plus an additional 10%.

As to *pension foundation reserves*, the rule is that the right to tax free allocation has been limited through the so-called lower ceiling. This implies that an allocation may be made at not more than the amount that has to be set aside in order that the foundation's capital *together with future allocations* shall suffice to ensure the payment of the promised pensions; the principle being that each year must be able to cover its own pension costs but not any costs in respect of future years. Corporations and other juristic persons may give bonds of debt to the foundation, while physical persons shall hand over cash funds.

Any other form of staff foundation may be established for various purposes, such as medical aid, spare-time activities, the building of holiday homes etc. An allocation may be made to an unlimited amount free of tax, but funds shall invariably be paid in cash to the foundation.

Besides these amendments to the rules governing the taxation of income it may be mentioned that the *rate of tax* to which corporations are subject for national income tax was raised from 40 to 50%. Municipal income tax varies in different municipalities but is likely to amount on an average to 12 to 14%. Since the municipal income tax is deductible when the national income tax is assessed, the average taxation on corporations may be estimated at about 56 to 57%. Seeing that the shareholders are taxed on their dividends, double taxation is imposed on that portion of the profits which is distributed to them.

Finally, it may be mentioned that the 12 per cent. *investment duty* which was imposed in 1952 and 1953, but which was abolished in 1954, was reintroduced in 1955.

The great majority of these amendments implied a definite tightening-up of the regulations previously in force. One exception having the opposite effect is the relaxing of the writing-off rules in favour of business other than corporations and certain other juristic persons. The new regulations governing investment reserves are in fact, in several respects, more favourable to business firms than the earlier provisions dating from 1947, although they afford the firms less possibilities of using the appropriated amounts as working capital.

The amendments to the tax laws adopted on the proposal of the Business Profits Tax Committee were all intended to serve as a link in the chain of measures to combat inflation. In the first place the intention was to reduce business firms' possibilities of financing investments and other expenditure by means of tax credit (i. e., a kind of interest-free credit through a postponement of tax payments). It was not considered that the credit policy pursued by the Government Authorities could become effective so long as businesses were enabled by means of unlimited write-offs on their machinery and equipment and by writing down their stocks to an almost unlimited extent to withdraw a substantial proportion of their profits from direct taxation and to employ the untaxed profits for financing investments and other expenditure.

The primary aim of the tax legislation was thus to weaken business liquidity. We must not, however, disregard the fact that most of the measures adopted also had the effect of worsening the business firms' profit-earning capacity. In the following pages we shall deal somewhat more closely with the effects on liquidity and profit-earning capacity.

Our Swedish business taxation is, in the main, framed as the taxation of net income. In principle, it is the profit calculated on a business economic basis that is taxed. The Business Profits Tax Committee discussed—in my view not particularly thoroughly—the question posed

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in the Committee's terms of reference whether, from the point of view of business-cycle policy, it might be considered expedient to convert business taxation either wholly or in part into some form of taxation of gross profits, e. g. a tax on expenditure. A solution on these lines was, however, rejected, and instead the suggestion was adopted of so revising the taxation on net incomes that it might serve a more useful purpose as an instrument of economic policy. Whereas the old system of free writeoffs and stock valuation was considered to have a directly stimulating effect on investments and thus to encourage inflation under boom conditions, the idea was to formulate rules to govern writing-off and the valuation of stocks which would be as neutral as possible from the business-cycle standpoint. In other words, their effect would be to tax reasonable and more or less realistic profits, and there would be no question of tax credit. Thus, the rules would be so adapted as not to affect business firms' inclination to invest.

The same may be said of the new rules restricting the right to make allocations to pension reserves. It has been considered that unlimited possibilities of making such allocations have resulted in their being in many cases in excess of the actual expenditure on pensions incurred during the year, so that advantage has been taken of the expedient of tax credit. The intention of the restriction in this field too was to bring about a neutral situation.

On the other hand, the same argument cannot apply to the rules governing allocations to investment reserves. These rules of law have nothing to do with the principles of business economy on which the calculation of profits is based but are purely an instrument of tax policy. The aim is to bring about a postponement of business firms' investments until some future time. We cannot therefore speak here of a neutral attitude in regard to investment activities. That is to say, by permitting firms to make tax deductions in advance for writing off on future investments the purpose is so to influence investment plans as to get them postponed until times that are more suitable from the business-cycle point of view.

Equally in regard to the raising of the corporation tax rate it is obvious that the desire has been to exercise a control over investment activities. The fact of having to pay higher taxes affords less scope for the self-financing of investments.

All the changes in taxation just referred to—the more stringent rules governing write-offs for depreciation, the valuation of stocks and allocations to foundation reserves, the new regulations in regard to investment reserves and the higher tax rate—apply to the taxation of income. The investment duty, on the other hand, is a tax on expenditure which aims directly at investments without going a roundabout way via net profits. It is quite evident that this form of taxation is deliberately designed to postpone or even to put the brake on investment activities.

The Writing-Off Rules

It was stated just now that the amendments to the tax laws adopted in 1955 might affect not only the firm's liquidity but also its profit-earning capacity. This applies, inter alia, to the tightening-up of the writing-off rules. That it would have the effect of worsening the firm's liquidity is self-evident—in fact, as we mentioned above, this was the primary aim of the amended law. The effect was, of course, quite different in businesses with a good and those with a poor profit-earning capacity. For the limits to what was the maximum amount that under free writing-off conditions could be written off with an effect on taxation were determined not only by the book value of the objects to be written off but also by the gross profit, by which is here meant the profit before write-offs and tax. The first of these two limits could be made elastic by finding new objects on which write-offs could be affected at once. The second limit, on the other hand, was not so easily affected if we disregard change in the writing-down of commodity stocks; writing-off and writing-down stocks have, of course, the same immediate effect as far as taxes are concerned.

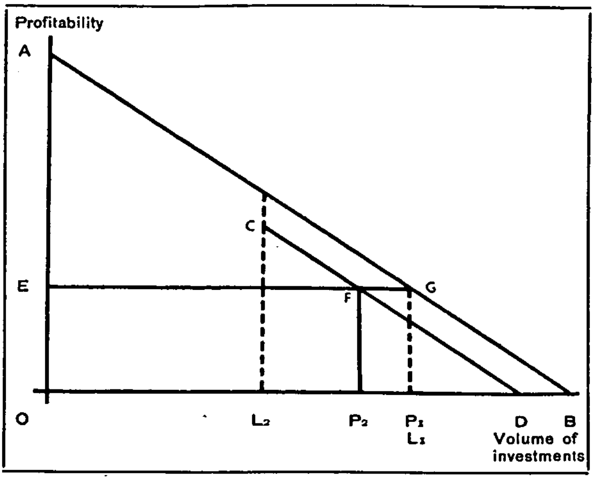
It is not certain, therefore, that firms with a relatively low profit earning capacity would be able to exercise their free depreciation right to the extent of writing off larger amounts than had been permitted since 1955, whereas firms making big profits have frequently had severely to limit their writing-off.

The right to make free depreciation allowances opened up the possibility of enjoying not only tax credit as such but also tax credit free of interest. If this credit had to be settled by means of a bank loan, for instance, the firm's profit-earning capacity was obviously bound to become weaker. A number of investment schemes which, provided they were financed on a tax credit basis, have been judged to be profitable, no longer pass the test of profitability when interest has to be paid.

It is probable that both these effects were in some measure relevant, though hardly to the extent that a certain limitation of investments had been caused by a simultaneous deterioration in liquidity and earning capacity, so that these consequences of a limitation of write-offs have apparently reinforced one another. On the contrary, the most correct way of looking at the matter seems to be this, that in certain situations it was the deterioration in the profit-earning capacity that had a deterrent effect and in other situations it was the deterioration in liquidity.

What we have just said may be illustrated by a diagram, in which we imagine that a number of investment schemes in a given firm have been arranged in order of their prospective profitability, those that have been judged to be the most profitable being placed furthest to the left. The line A—B indicates the profitability at the starting point, which presumes the right to free writing-off, enabling the firm to utilize tax credit free of interest.[1] However, the management of the firm demands a certain measure of profitability if the projects are to be successfully carried through, and this is denoted by the line E—G. This means that projects P_1—B must be given up, and only O—P_1 remain. We assume that by exercising its right to free writing-off the firm is able to create the liquidity that is required in order to finance these projects. Point P_1 (the limit of profitability) therefore coincides with L_1 (the limit of liquidity).

[1] We have here made a simplification in that the curve becomes a straight line, which would hardly be the case in reality.



Now let us imagine that the right to free writing-off is replaced by a right to effect write-offs in accordance with the new rules governing depreciation charges on an accounting basis. Part of the liquid funds that were formerly available for investments must now be paid away in taxes. If no fresh funds are procurable by borrowing, etc., the liquidity limit is moved from L_1 to L_2, and the investments L_2—L_1 consequently lapse in spite of a proportion of them still being profitable. Should, on the other hand, loans be obtainable, then the investment schemes that are financed by these loans will yield less profit owing to the interest charges. It has been assumed here that the least profitable investments are financed by this means, and in that case it will be the investments to the right of L_2 that will have to pay the interest. The new profit earned from these investments will be C—D, and as that line bisects E—G at point F the investments lying to the right of P_2 are bound to become less attractive. And so it will be P_2 that now constitutes the limit, although the limit of liquidity L_1 remains unchanged.

A numerical example may illustrate our reasoning. A firm has liquid funds totaling 100,000 kronor and a profit (before write-offs and tax) of a like sum. The elder machines have earlier been fully written off. If the firm does not make any investment that may immediately be written off, the total profit must be stated in the income tax return, the tax being assumed to be 50% = 50,000 kronor. Let us assume instead that the profits are invested in machinery and that the entire cost of procuring it, 100,000 kronor, is at once written off. Then there will be no tax to pay, and the method of financing the purchase is a combination of self-financing and financing by way of tax credit. In the diagram the line O—L_1 is assumed to represent the sum invested, 100,000 kronor.

Let us suppose now that the tax regulations have been tightened up, so that the firm has to be content with a 30% write-off on the investment. Seeing that now there is a tax to be paid, the liquid funds will be reduced, and if no other sources from which to finance the investment are available, the investment too will have to be on a smaller scale. The maximum sum that can be invested may be calculated as follows (amounts in thousand kronor):

INVESTMENT I

$$\text{Write-off } \frac{30 \cdot \mathrm{I}}{100}$$

$$\text{Tax } \frac{50}{100} \cdot \left(100 - \frac{30 \cdot \mathrm{I}}{100}\right)$$

Since the investment + the tax = available liquid funds, we get:

$$\mathrm{I} + \frac{50}{100} \cdot \left(100 - \frac{30 \cdot \mathrm{I}}{100}\right) = 100$$

$$\mathrm{I} = 59$$

Accordingly, owing to the weakening of the firm's liquidity position its investments have to be limited to 59,000 kronor, corresponding to L_2 in the diagram. If, on the other hand, the amount that corresponds to the tax can be borrowed it will still be possible to invest 100,000 kronor, although on account of the interest payments it is assumed that this investment will not prove sufficiently profitable, so that the investment programme is reduced (in the diagram to P_2).

There may be reason to presume that in the great majority of cases it is the effect on the firm's liquidity of the restriction on writing off for depreciation that has been of most significance. Under boom conditions a far larger number of schemes are usually judged to be profitable than the financial possibilities would justify. Even after some falling-off in profitability has occurred the total number of profitable schemes may be greater than the supply of capital.

In the introduction to this article it was pointed out that the Business Profits Taxation Committee had aimed at drawing up writing-off rules that were neutral from the business-cycle standpoint. Essentially, of course, any tightening-up of an entirely free right to effect write-offs is bound to have the effect of suppressing investment activities during a boom. The gist of the argument is that the right to write off should be limited to sanctioning such write-offs as may be justified from the point of view of business economy and such as do not entail the postponement of the payment of tax on any profit that may have been earned. The writing-off percentages recommended by the Committee and subsequently confirmed by law (30% on the book value or 20% on the cost value) were in the Committee's view sufficiently liberal to enable the private firm to pursue consistently a given writing-off method devised on a theoretical basis. Although narrower limits might be justified on the grounds of trade-cycle policy, the Committee did not consider that it could recommend any further restriction seeing that it was a question of general writing-off percentages applicable to all business sectors.

So long as stable price conditions prevail, it is no doubt quite correct that in the great majority of cases the new rules allow fully adequate writeoffs from the business economy standpoint. The problem becomes more complicated in a situation in which prices are rising. If the aim of a firm's writing-off policy is to be able by means of its depreciation funds to finance its replacement purchases, the write-offs must be calculated on the assets' current replacement value and not on their original cost value. Further provisos to ensure that these write-offs shall be adequate are that the writing-off period is correctly computed and that the depreciation funds are invested in capital goods the value of which lasts as long, or which follow the same price trend, as the objects that are written off.

Now, we are all aware that the new rules do not—any more than the rules governing free writing-off—accept any value other than the original cost value as the basis for writing-off. Is it nevertheless possible in the event of prices rising to obtain a sufficient amount of depreciation funds for financing reinvestment on the required scale? To enable us to answer this question we must know something not only about the rate at which prices rise but also about two other factors, viz. the period during which the assets should on business-economy principles be written off, and the manner in which the investments develop.

First of all, we can confine the discussion to the subject of one individual machine. If the price increase is continuous, then the depreciation funds saved by the firm when writing off under the tax regulations can never, of course, be as large as if the write-off had been estimated on the renewal value. This holds good irrespective of the length of the period in the latter case. If, however, the "correct" writing-off period is essentially longer than the five years within which the writing-off for tax purposes is allowed to be effected, in certain circumstances the interest on the depreciation funds may compensate for the write-offs' not having been allowed to be computed on the rising renewal value, though this presupposes a very moderate price increase.

It is, however, a matter of greater interest to examine the writing-off problem as it affects the entire aggregate of objects subject to depreciation, e. g., the entire mechanical equipment. Let us, then, first assume that procurement takes place continuously without any expansion. It is not possible here either for the write-offs for tax purposes ever to reach the same annual amounts as the total written off on the replacement value so long as the price level goes up. This applies irrespective of the percentage at which the write-off is effected. Writing off at a rate of, say 5% on the replacement value is bound, if prices are rising, invariably to yield greater annual write-off amounts than it would at the rate of 20% on the original cost value as far as the mechanical plant as a whole is concerned.

The position may be quite different in the case of expansive investment. The fact that the initial write-offs permitted for tax purposes are calculated at a high percentage on an ever-increasing volume of investments may cause the annual write-off to be for a higher amount than when calculated on a current value that has increased owning to a rise in prices but at a lower writing-off percentage. As we have to take into account three different variables (length of life in service, the rise in prices and the degree of expansion) it becomes a complicated matter to show generally under what conditions this may take place.

In regard to *building*, no appreciable amendments to the writing-off rules were made in 1955. Generally speaking, as regards industrial buildings 2 or, at the most 3% are allowed for write-offs on the procurement value or the assessment value. As it is here a question of assets having a longer life than that of machinery, the difference between the procurement value and the replacement value is often considerable during a long period of inflation. In the majority of cases, therefore, it may be impossible to finance replacements by means of depreciation allowances.

The Rules Governing Stock Valuation

Just as a firm that effects radical write-offs on its fixed assets may postpone its statement of profits and consequently—insofar as its write-offs are accepted for tax purposes—its tax payments, the same effect can be obtained through writing down stocks more heavily than is required on the grounds of business economy. This tax credit may then be utilized for financing not only an increase in stocks but also fixed assets and expenditure generally. If the rules setting a limit to writing off are to have the effect of controlling the business cycle, they must be supplemented with rules that set a limit to the valuation of stocks. This was the argument of the Business Profits Taxation Committee, and purely as a matter of principle it must be considered correct.

If, now, we look at the problem from the financing point of view, the opinion is frequently expressed alike in the literature on business economy and by practical businessmen that the profit should be so calculated that consumed or sold stocks can, even if prices go up, be replaced without the firm's requiring to obtain capital from outside. I would not assert that this view is the only correct one from the standpoint of business economy, since opinions may differ as to the aim of matching the profit. However, there is much to be said in favour of the principle that a firm should not account for, be taxed for and pay dividends on a larger amount of profit than that which arises after the firm's capacity for holding stocks has been financially assured.

Nor can anyone claim that the adoption of such a principle in accounting for profit may have the effect of encouraging investments and intensifying inflation. It is not a question of enabling the firm to finance free of tax some increase in stocks or an expansion in some other field but merely of preserving its hitherto existing capacity.

When it comes to seeing to what extent the stock valuation rules provide for business firms' financing requirements in this respect, we should first of all remind ourselves that the main rule is based on a certain formally fixed rate for writing down the stocks' current value at the time of the closing of the books. This value is either the cost value according to the rule "first in—first out," FIFO—or the replacement value, whichever is the lower, a certain deduction being allowed for goods that are no longer in demand. After the new rules have come fully into effect in 1959, the current stock valuation obtained in this manner may be written down by 60%, i. e., to 40%.

These writing-down possibilities may appear to be extremely favourable for business firms—and there is no denying that the Swedish valuation regulations are far more favourable than corresponding rules in many other countries. Nevertheless it is questionable whether the rules are satisfactory under all circumstances if due heed is paid to the firms' financing requirements.

It is open to discussion whether our Swedish firms do actually write down their stocks. Should not the current value (i. e., the lowest value as indicated above, due regard being paid to goods no longer in demand) be only correct balance-sheet value when estimating the firm's true profit?

Since in the field of business economy stock valuation is frequently accepted at a lower value than that just mentioned, this is dictated mainly by two motives, which need not necessarily be in accord with one another, nor are they in direct contrast with one another:

(1) A fall in prices may be expected.

(2) Prices have gone up.

As to the first motive, it is a common one in Swedish business economy. It forms a link in the chain of efforts commonly made in Sweden to level out the results as between good and bad years. When commodity prices are high, it usually means good times and consequently god profits. When market conditions change, prices fall and profits are lower or turn into losses. By establishing secret reserves in stocks during prosperous years and drawing on them in less satisfactory years the graph showing the results becomes more regular than it would otherwise have been. From the accountancy standpoint losses can be avoided in this way, and this is an advantage from the tax point of view so long as no open leveling-out of losses is permitted.

It may be mentioned that this levelling-out method is by no means universally accepted abroad. The view is not uncommonly held that the firm is bound as far as is possible to show a realistic result each year—even if the result should be a loss. In that case, however, it is often permitted for tax purposes to set off the loss against profits earned in other years.

If an attempt is to be made, taking as our starting point *the risk of a fall in prices*, to judge the reasonableness of our main rule on stock valuation, we are bound to consider it to be very liberal, regarded as a general rule. Although there are, of course, firms whose stocks may be expected to decline in value by 60% at current prices, this can by no means apply to all businesses. We can imagine, for instance, a firm that is now being started in a line of business that is not particularly sensitive to price fluctuations on a capital of, say, 100,000 kronor, which is invested in commodity stocks. After a year's trading the firm has the same stock in hand, which may be assumed to have neither risen nor fallen in price. Although no fall in prices need be expected in the prevailing situation, the firm is nevertheless enabled to write down its stocks to 40,000 kronor provided the gross profit is large enough to permit its doing so. By this means the firm obtains—if the tax rate is 50%—a tax credit of 30,000 kronor, which can be utilized to finance the firm's investments. As it is here not a question of re-investments but of new investments, the system of taxation contributes towards enabling an expansion in this case.

It is of course unlikely that so large a write-down as 60% can be effected in a year, seeing that a newly started firm does not usually make such big profits. But even if the writing-down is done in stages, the effect will be the same, although at longer range.

From the above remarks the reader may easily get the impression that the author is in favour of more stringent valuation rules. This, however, would be to draw too hasty an inference. In the example given, it was a question of a firm that had not experienced any rise in prices and one in which the risk of a fall in prices could not be regarded as particularly great. Let us now see instead how the rule works in the case of a firm that has been conducting business during a long period of *rising prices*.

First, however, we can confine ourselves to studying the effect of the rise in prices in the course of a single year. We may assume, as we did just now, that a firm invests 100,000 kronor in a stock of goods. This is sold for 150,000 kronor but has to be replaced at once at a price 20% higher, i. e., at 120,000 kronor. How large is the profit earned by the firm? Some will say 50,000, others 30,000. The answer depends on how we define the term "profit". If we make it as our objective in ascertaining the result that the profit shall not comprise any of the capital that is required for keeping the original stocks quantitatively unchanged, then the profit is only 30,000 kronor. In the firm's books this profit will appear through the stocks' being booked at 100,000 kronor, not at 120,000 kronor. Thus far, in fact, the tax regulations are satisfactory in that they permit of the stocks being written down from 120,000, which the law deems to be the proper stock valuation, to 100,000 kronor (and lower, if desired).

Now, however, assume that on the first occasion the stocks had already been acquired before the war at 100,000 and that they are now worth 500,000 kronor at the day's price. In quantity the stocks are the same as at the outset. Should they be kept financed throughout the period without any additional capital, the amount corresponding to the rise in prices must be kept outside the profit statement, this being achieved by maintaining the value of the stocks throughout the period at 100,000 kronor. The tax rules, however, do not permit the stocks to be valued at less than 200,000 kronor, which means that the difference—100,000—has been taxed during the period. From the standpoint that is relevant here, this amount is to be regarded as a fictitious profit. An amount equivalent to the tax paid will have to be contributed for financing the gradual procuring of the replacements.

In a situation of this kind, then, the tax rules must have an effect exactly the opposite to that in the first example. If the demand that the rules shall be neutral in regard to business firms' investment activities and financing requirements is to be consistently met, then the rules should have been based on some form of "base stocks" method or on the valuation rule that is akin to it: "last in—first out", LIFO.

The percentage writing-down method based on the FIFO value likewise has this disadvantage, that a quantitative change in stocks no less than one caused by price movements involves respectively an increase and a diminution of the secret reserve formed through writing down their value, so that profit and tax alike are affected in an unsystematic manner. The supplementary rule applicable in the case of a diminution of stocks under which the secret reserve must be calculated on the average of the two immediately preceding years' stocks has, however, its merits, and the same may be said of the other supplementary rule governing raw materials and staple goods. Both these rules have a financing effect which to some extent and in different respects is similar to base stocks valuation, but it should perhaps be pointed out that they cannot for any length of time contribute towards maintaining the firm's business capacity.

The Investment Reserves

As was mentioned in the introduction, the aim of the investment reserves is to exert a direct influence on business firms' investment activities. One of the most important innovations in the legislation passed in 1955 on investment reserves is that 40% of the amount set aside shall be blocked by being deposited in the Riksbank. It can certainly be said that the effect of the earlier investment reserves on business-cycle policy was extremely small, if they had any effect at all. On account of the strict rules governing their reinstatement for tax purposes after a certain time only insignificant amounts were set aside. And in those cases in which such appropriations were made, there was no need whatever to sterilize the funds placed to reserve, the consequence of which was that they could very well be immediately invested in the business—which was not at all the intention.

The 40% sterilization has this substantial advantage from the point of view of business-cycle policy, that the reserve cannot be invested in its entirety before permission to do so has been obtained, i. e., in a situation in which it is considered that investment activities should be encouraged. When that time comes there is always available some portion of the liquid funds necessary for financing purposes—which could not be presumed to be the case in regard to the earlier reserves. The ideal, from the business-cycle standpoint, would have been for 100% instead of 40% to have been sterilized, but the consequence would undoubtedly have been that no firms would have been interested in making allocations to a reserve, since it would have been more advantageous from the point of view of liquidity to pay the tax on the profits. Thanks to the amount to be sterilized being made lower than what the tax would have amounted to, firms are enabled to improve their liquidity somewhat by setting money aside to a reserve. This possibility of improvement has been further enhanced through the tax rate being raised—which the Business Profits Taxation Committee had not foreseen.

In spite of 40% of the reserved amount having to be paid in to the Riksbank, firms do not necessarily find themselves in a very much worse liquidity position if the reserve system of 1955 is applied to 100% than if the 1947 rules had been in force; for nowadays 40% of the profit may be set aside annually as a business investment reserve—as compared with, as a rule, only 20% formerly. If, then, the profit on which the allocation has to be calculated amounts to 100,000 kronor, 40,000 kronor may now be set aside, of which amount 16,000 kronor has to be deposited in the Riksbank. The tax is 60,000 kronor; at a tax rate for national and municipal income tax of 57% it thus works out at 34,200 kronor. Altogether the firm parts with 50,200 kronor. According to the regulations passed in 1947 the amount set aside would be 20,000 kronor and the tax at the current tax rate would have amounted to 57% of 80,000 kronor=45,600 kronor. The decline in liquidity under the new system compared with the old is thus 4,600 kronor.

A number of quite substantial advantages of the new system over the old should be noted. Nowadays, for instance, firms need not reinstate the reserves for tax purposes after a certain period. However, the Labour Market Board may require that in a certain market situation the reserves shall be utilized, and if for any reason this is not done the amount set aside is subject to tax plue 10%. On the other hand, the firm is allowed a 10% reduction when by permission of or by order of the Labour Market Board the reserve is used for investment purposes.

Another advantage is that after 5 years the firms may without obtaining permission dispose of 30% of the amount set aside for investment purposes, a corresponding proportion of the balance in the Riksbank being withdrawn with that object.

Further, the fact that when setting aside an amount to reserve it is not necessary to state the exact purpose must be regarded as an improvement. It is only when the time has come to utilize the reserve that a decision has to be made. Formerly it had to be indicated already at the time of making the appropriation whether the reserve was intended for investment in buildings, machinery, etc.

A number of businessmen have shown an manifest interest in the new investment reserves, while others have adopted a more reserved attitude. In their choice between availing themselves of the possibilities of writing-off, writing down stocks and placing to investment reserve firms have quite often chosen the two first-mentioned alternatives. The primary explanation of this is no doubt that placing to reserve, in contrast to writing off and writing down stocks, at once worsens their liquidity. Insofar as there are no objects that can be written off or written down or—as many firms will find in the next few years—insofar as it becomes necessary to write up the value of stocks compared with an earlier valuation, the investment reserves are likely to offer advantages to those firms which need to improve their liquidity.

The Rate of Tax

Like the restriction on the right to write off and write down, raising the tax rate for the national taxation of income earned by corporations from 40 to 50%—that is to say a 25 per cent. rise—has the effect of weakening business firms' liquidity. In one essential respect, however, there is an important difference in the mode of operation.

The aim in tightening up the writing-off and writing-down rules is not definitively to deprive the firm of funds but to reduce the firm's possibilities of obtaining tax credit. The total tax (apart from interest) should in the long run amount to the same sum as under conditions of free writing-off and stock valuation provided that the firms are not enabled on the grounds of expanding their business to make the tax credit permanent. A further proviso is that the tax shall be levied according to the same principles, so that any change in the taxation shall not entail the profit's being taxed at a higher or a lower rate.

In contrast to that possibility, raising the tax rate will involve the firms' being *definitively* deprived of a larger proportion of their profits than before. This will reduce their chances, not only in the short run but even in the longer run, of conducting their investment activities on a self-financing basis.

If the aim of raising the rate of tax is to weaken the firms' investment possibilities, this aim is in reality counteracted by the fact that it creates a stronger inducement for the firms to take steps to reduce the amount of profit accounted for, thereby reducing the tax as well. These steps may consist in investing or spending on a greater scale than would otherwise have come into question. The limitation imposed on the right to effect write-offs has naturally reduced the possibility of immediately obtaining tax relief by that means, but when the rate of tax is so high as 55 to 60% the possibility of making an initial write-off of 30% would also probably act as a powerful inducement to invest.

Moreover, there are the very unfavourable effects of a high tax rate upon a firm's chances of procuring fresh venture capital. If a new issue presumes a dividend of 6 to 7%, the capital in the hands of the firm must give a 16 to 18% yield before tax (account being also taken of compulsory reserving). The tax system has this unfortunate effect, that the requirement of profit-earning capacity is bound to be highly differentiated in regard to capital that has been acquired through contributions from the shareholders, by self-financing and by borrowing.

The Investment Duty

The investment duty is an extra tax on business firms' investments and, as mentioned above, may be placed in the category of gross taxation or, to be more precise, taxation on expenditure.

It is obvious that an investment duty entails both a worsening of liquidity and a worsening of the profit earning capacity. The worsening of liquidity is offset in some measure by the duty's being deductible upon the assessment for income tax. At so high a tax rate as 55 to 60% the improvement in liquidity gained through the deduction is not entirely insignificant.

There would not seem to be much objection, in pinciple, to an investment duty's being imposed at times when investment activities are considered to be far too expansive. If, however, it is to be counted upon to have its full effect, the duty must be a temporary one and not made permanent. For an effect designed to postpone investment must always be stronger than one that definitely aims at putting a brake on investment. If firms have reason to believe that the investment duty will be imposed for a long time ahead, they will soon adapt their estimates of earning capacity and their financing plans accordingly. Perhaps only the least profitable projects will be abandoned. If, on the other hand, one can rely upon the duty's being merely temporary, it is likely that even more essential and profitable investments can be postponed for a year or so.

Nevertheless, a decided disadvantage of an investment duty which, though of short duration, has been imposed at short notice is that it cannot invariably achieve the effect intended owing to the firms' having made their plans and resolved upon their investments far in advance. The investment is frequently of such a nature that it is impossible to upset the plan without serious difficulty. In that case the duty does not have the intended effect of postponing the investment, and the chief result will be that an extra burden will be placed on the firm's liquidity and earning capacity, which may perhaps not have any reaction upon its investments until a situation arises in which a restriction on investments is no longer necessary.

In another context the writer has suggested the desirability of enabling an investment duty to be supplemented by something having the opposite effect, viz, by investment premiums at times when it is considered that business investments need a stimulus.[2] Situations are conceivable in which it is not sufficient merely to abolish the investment duty and some of the other measures designed to limit investments, but positive action has to be taken. It would not be out of place perhaps to consider now at once how this can suitably be done.

What Forms of Relief in Business Taxation Are of the Greatest Urgency?

In the book "Recept mot inflation" (A Remedy against Inflation) two professors have expressed themselves in favour of moderating company taxation in the prevailing situation. Professor Erik Lindahl writes:

> Saving by business firms should be facilitated by a revision being undertaken of the rules governing valuation and writing-off and also by reducing the percentage rate of the corporation tax.—Formerly very liberal rules were applied to valuation and writing-off. The recently undertaken redrafting of these rules has actually entailed a substantial increase in the taxation of business firms, particularly in regard to companies. At the same time the corporation tax has been raised, albeit only temporarily perhaps, from 40 to 50 per cent. This double tax increase hits corporations with all its force just as they have left the high-profit phase of the inflation behind them and are trying to find their bearings in a tightened-up economic situation with only moderate earnings—apart from purely book profits derived from writing up assets at a time when the value of money is lower. Unless, therefore, the taxation of businesses is revised, it is to be feared that there may be a drastic decline in saving by firms—a serious matter particularly in view of the great importance attaching to this form of saving for financing the creation of capital in industry.

Professor Erik Lundberg dwells at length on the question of freer credit—and a capital market that would provide better conditions for effective competition on the commodity market. In this context he writes:

> These arguments provide sound motives—over and above those that are usually brought forward—for lowering the prevailing unreasonably heavy taxation of business profits. From the standpoint of the necessary supply of business firms' saving—a decline cannot be made up from other sources—a lowering of the tax is justified if and when under the pressure of a strict credit policy and effective competition the level of gross profit shows a downward tendency. From its general aspects it is more satisfactory to have a relatively low level of profit due to effectively functioning competition on the credit and commodity markets than to arrive at this result with the aid of high tax rates. In actual fact, a substantial lowering of the present abnormally high tax rates is regarded as a vital *prerequisite* for bringing about a better equilibrium on the credit and capital markets. Borrowing from a bank or taking up a bond issue is obviously an unreasonably cheap method of financing especially when a depreciation of the value of money is expected—compared with financing out of its own funds or by an issue of shares. This serious distortion of the costs of financing for investment purposes which thus contributes toward increasing the pressure on the loan markets and maintaining the margins of profit, would be weakened if the taxation on businesses were reduced to a reasonable level.

We are no longer in a situation in which investment activities in the private sector are carried to extremes. Even from the economic point of view it would seem expedient to give firms a freer hand in carrying out their investment programmes. Technical progress makes it essen-

[2] Ekonomen No. 20/1956.

tial within the immediate future to venture upon long-term investments. Insofar as the community's capital resources are insufficient, it would be more in keeping with the situation to limit consumption than to limit investments.

In the situation as it is today the most urgent step from various points of view is drastically to reduce the rate of tax. Reversion from 50 to 40% is not an adequate scale of reduction. Only if the tax rate were brought down to 20 or 30% should we get rid of the worst distorting repercussions. Alternatively, it is conceivable that the tax rate might be reduced to 40% only, but that the right to deduction for a certain amount of dividend might be introduced. This deduction would then have to be computed on the entire capital and reserves accounted for, preferably not merely on the share capital. However, this system, compared with that entailing a lower rate of tax, has the disadvantage that the marginal tax will still be high, with all the distorting effects that involves.

Cutting down the tax rate to half would deprive the Government of 600 to 700 mill. kronor in tax revenues, presuming the taxable profit to be the same as before. According to a Committee's recently published report, the estimated revenues from an all-round indirect tax on consumption work out at 210 to 270 mill. kronor *for each percentage of tax.* Would it not be worth discussing whether a turnover tax of a few per cent. would not be a conceivable alternative to the existing irrational rate applied to the corporation tax?

Further, in regard to stock valuation it would seem to be a matter of urgency to introduce a supplementary rule to the effect that business firms would be allowed to apply some form of base stocks system whereby they could be guaranteed that a quantitatively unchanged volume of stocks might be kept financed without any additional supply of capital.

As pointed out above, no sound justification for the investment duty can be said to exist in the present situation. Pursuant to a resolution of the Riksdag, this duty will moreover cease to be exacted next year. It will then be superseded by another tax on expenditure—the energy tax—which is calculated to have a less restrictive effect on investments.[3]

The writing-off rules, on the other hand, would probably in most cases give firms adequate scope for effecting write-offs that would be fully justified from the point of view of business economy so long as the rise in prices is moderate and the volume of investment is allowed to expand somewhat. In the case of buildings, however, more practical rules should be introduced making it permissible to write off on the current procurement value.

The right to an open leveling-out of results as between different income years is likely to be granted in the near future, now that a new committee has been given the task of investigating the question further. A reform on these lines is, of course, a matter of great urgency.

It not infrequently happens in public discussion that too much stress is laid on the significance of improving those rules which are only concerned with periodizing, and far too little importance perhaps is attached to the essential point, that is to say, bringing about that definitive improvement which a lower rate of tax implies.

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[3] For reasons of space, it has not been possible in this dissertation to discuss the intricate problems connected with this and other forms of taxes on expenditure.

THE SWEDISH NATIONAL BUDGET—"A TENTH ANNIVERSARY"*

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Together with the state budget, which is submitted to the Riksdag in January every year, a national budget, or Economic Survey, is customarily presented. This national budget is nowadays the result of a couple of months' intensive work in the Economic Section of the Ministry of Finance, with the assistance of experts from various authorities such as the Labour Market Board, the National Board of Trade, the National Institute of Economic Research (konjunkturinstitutet) and the Office of Public Accounts. For some years—at present, regularly—revised national budgets have been presented at the end of April in connection with the revised state budget, which contains the final proposals for a budget on government incomes and expenditures during the coming fiscal year. The national budgets are also published (with a summary in English) in series B of Reports from the National Institute of Economic Research (Meddelanden från konjunkturinstitutet).

The contents of the national budget can be described as a discussion of the general economic development in the coming year, so far as this can be estimated on the basis of the preliminary national economic accounts for the calendar year just ended. It can also be said to show the expected results of the economic policy that is presented simultaneously with it in the state budget. The quantitative part of the discussion takes the form of a balance of resources for the coming year, i. e., a table showing the expected total supply of goods and services within the country, and the use of these for different purposes. In the table below is shown, as an example, a balance of resources for 1957, as it appears in the revised national budget for that year.

The estimated balance of resources is based on the preliminary survey of the previous year's development, compiled in the Institute of Economic Research—the availability of material on the national accounts for the previous year is a precondition for the work on the national budget. Besides this, statistical material is received from a number of government bodies concerning both the past and the coming year—the latter frequently in the form of statistics on plans.

*Skandinaviska Banken Quarterly Review, vol. 38, No. 4, October 1957, pp. 100–107.

Estimated balance of resources for 1957

[Million kronor at 1956 prices]

	1956	1957	Change, 1956–57	
			Million kr.	Per cent.
Supply:				
Production	52,700	54,100	+1,400	+3
Imports	11,450	11,750	+300	+3
Total supplies	64,150	65,850	+1,700	+3
Use:				
Private investments	9,050	9,300	+250	+3
Public investments	6,550	6,950	+400	+6
Increase in stocks	750	250	−500	------------
Exports	11,250	11,950	+700	+6
Private consumption	30,150	30,650	+500	+2
Public consumption	6,400	6,750	+350	+5
Total use	64,150	65,850	+1,700	+3

The first national budget in Sweden was prepared for the year 1948. Thus it can be said that the national budget celebrates its tenth anniversary this year. The past decade has been a very eventful one from an economic point of view, and this has been reflected in the work on the national budgets. Although the form and technique have changed in some respects, the disposition of the national budgets is nevertheless still largely based on the 1948 model. The aim of this article is to attempt to give a brief account of the scope and the development of the work on the national budgets.

The Administrative Framework

Before the 1930s the government finances were discussed in the state budget, roughly speaking, without any direct connection with the general economic development. During the depression of the 1930s, however, there began a new phase of economic policy, in which fiscal policy came to play a much greater role as an active instrument of counter-cyclical policy. Because of this there was also an increase in the demand for general economic information, and so in 1937 there was founded the National Institute of Economic Research with the task of surveying and analysing economic development.[1] Until the end of the 1940s judgments in the state budgets on the general economic situation were based on the investigations conducted within the Institute of Economic Research.

Immediately after the war, when there were great shortages in all sectors—of raw materials, labour, goods etc.—and the use of the available resources was to a considerable extent centrally administered, the analysis of economic development came to depend to a large extent on information from various authorities about their plans (plans for imports, for the issue of building licenses, etc.). It was therefore considered suitable to establish a closer link between economic forecasts and the shaping of general economic policy, which had to take place within the government ministries. This led to the establishment of the national budget delegation in 1947. This delegation, which

[1] See the article by Professor Bent Hansen in the previous issue of the Quarterly Review.

became a forum for the discussion of future economic development, had as its task to summarize its judgements of the future in an economic survey for the coming year.

The idea of making national budgets in Sweden had certainly been inspired by similar work in a number of other countries. An ambitious scheme of this type had been started, for instance, in the neighbour country, Norway. The method which was to distinguish the work on economic forecasts in Sweden had not, however, been inspired to any great extent by other countries. It was the 'inflationary gap calculations'—i. e., calculation of the strain ex ante between demand and supply—, previously developed by the Institute of Economic Research, that came to serve as a model for the national budget work. Calculations of this type had been carried out within the Institute for the first time in 1943. It may, however, be mentioned that the surveys which the national budget delegations produced bore a considerable resemblance to the British 'Economic Surveys' of that time.

The national budget delegation comprised originally five members from the government administration, under the chairmanship of Karin Kock, then a cabinet minister, and to it were attached a number of experts from various organizations and authorities; the delegation was enlarged in the course of the years by the addition of new members. The first result of the work of the delegation was presented together with the budget proposals for 1948–49 in the form of a calculation of excess demand with the title 'Discussion of the problem of economic balance for the year 1948.' In the spring of 1948 the first more complete economic survey for the coming year was published. The word 'national budget,' as title for the results of this work, was first used in the survey for 1950. In the same year the national budget office was linked to the Ministry of Finance.

In 1954 three new organs, of some significance for the national budget work, were established: a co-ordinating committee for discussions about economic policy, a board for the planning of measures for economic stabilization, and a research council. The research council, which consisted of representatives of various economic research institutes within the government administration and economic life[2] had the task of discussing the national budget, in an advisory capacity, while work on it was in progress. The national budget office had to act as an office for the stabilization board as well. The co-ordinating committee, which consisted of leading men within the administration, and in whose deliberations members of the government took part, was to be a forum for economic discussions and was to approve the national budget.

The co-ordinating committee and the stabilisation board were abolished in 1956. There remains, however, the research council to discuss the national budget while work on it is in progress. As before, the members of the council have no responsibility for the final shape

[2] The directors of the Industrial Research Institute, the Agricultural Research Institute, the National Institute of Economic Research, the Research Department of the Confederation of Trade Unions, and the Research Department of the Central Organisation of Salaried Employees.

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of the national budget. On the 1st July, 1957, the national budget office was changed into an economic section within the Ministry of Finance.

THE CONTENT OF THE NATIONAL BUDGET WORK

The most important use of the national budget work is, of course, as an aid to economic policy. As an instrument for this purpose the national budget work can, in principle, be given the tasks of prognosticating developments with a given economic policy, and of suggesting what various combinations of political means can be used to reach a given desired economic position.

It is quite obvious that it is important to obtain a picture of the economic situation and of the effects of a policy, when economic policy is being formed. In the national budget work an attempt is made to set forth the tendencies in the economic development against the background of the economic policy being pursued. Such work can be of use in every country where there is an economic policy, regardless of the degree of state control of economic life. But the greater the amount of direct regulation in the economy, the greater can be the additional task for the national budget work of acting as an instrument co-ordinating economic policy. In such cases the budget has much the same duties as the budget within a firm. This co-ordinating duty has sometimes been regarded as having an important use in the Norwegian national budget.

When an attempt is made, starting out from the current situation and working from certain hypotheses, to estimate the economic situation for the coming year, this can be regarded as a prognosis. It is a national prognosis—contingent upon the economic policy that is pursued. The concept of a national budget seems most suitable when the prognosis is made available to those responsible for the economic policy. The term budget in its present meaning ought to be presumed to imply an independently working body. Thus the national budget would be interpreted as a prognosis accepted by the authorities, as something similar to a programme.

Let us look, however, at the national budget as it is presented in Sweden. This aims at giving a picture of economic development regarded, among other things, as the effect of the economic policy adopted. The conclusions put forward in the national budget do not, therefore—if a suitable reliability can be attributed to them—, strive against the intentions of economic policy, looked at in the light of what methods of economic policy it is considered possible to use. This is not to say that the various figures in the national budget make up a programme. Certain figures represent perhaps a programme (e. g., the target for the regulated investment activity), while other figures might be considerably changed without involving any change in economic policy—the possibilities of directing economic development by economic policy are, of course, limited in a society of the Swedish type.

National Budget Technique in the First Years

The quantitative part of the national budget work consisted originally of two sections. The first was a calculation of the excess demand, or inflationary gap, as it was at first called. The other showed how the available resources (production and imports) were expected to be distributed among the various categories of use (investment, consumption and exports). There was a close connection between the working out of these two calculations. The second could be said to be a by-product of the first. The discussion of the tendencies in developments in the various sectors took place largely with reference to the building up of these calculations, although this discussion was probably of greater interest and value than the precise figures themselves.

The calculation of the excess demand took place in the following way. The basis was a calculation of production. With the strong pressure of demand then prevailing it was assumed that full employment and "maximum" production could be counted on except in so far as bottle-necks for fuel and raw materials hampered production possibilities; the production calculations were based to a large extent on previous experience of developments in production. After the gross national product for the coming year had been determined, this was corrected for exports and imports. As long as the major part of imports were subject to regulation this correction could be done according to a definite scheme. Exports were estimated independently, and after this a calculation could be made of the imports of goods that should result from the plans of the import regulations.

When total resources, i. e., production plus imports, had been calculated at fixed prices and exports subtracted, the remaining resources had to be divided between gross investment (private and public) and public consumption. For investments and public consumption statistics on plans for the coming year were available. Then, after a correction had been made for expected changes in stocks (in some sense), the remainder was left for private consumption. Thus the calculation showed how much was left for private consumption after the other sectors had obtained their share—on the assumption that development took place according to the existing plans in the various sectors. This was the supply side in the inflationary gap calculation.

By investigating the probable development of personal incomes, taxes and savings, an estimate of the probable demand for consumption goods at given prices could also be obtained. The difference between this demand and the supply calculated as above gave a measure of the excess demand.

To the extent that there was an excess demand, if the economic policy was not changed, demand and supply would have to be adjusted to each other during the course of the year. Some aspects of this adjustment were touched on in the earlier national budgets, and the final result of this type of national budget analysis was a table of the balance of real resources and their distribution.

Thus this earlier national budget work was characterised by the fact that the different items in the balance of resources were estimated fairly independently of each other. The various items were obtained from different authorities. Thus the task of the national budget could be said to be to investigate how the plans of the various authorities fitted together. The national budget work did not, however, imply any decisions on priorities in the use of available resources. Another characteristic was the assumption of full employment and a fixed price level in the calculation of the excess demand (and of the distribution of resources).

Later National Budget Technique

When the strong pressure of demand of the immediate post-war years relaxed, and other moods of economic activity were experienced, the methods of national budget calculation were also changed to a certain extent. For instance, when, immediately after the Korea inflation, the economic situation in Sweden, as in many other countries, was marked by a certain degree of stagnation, the national product could no longer be calculated independently. Production became more dependent on the development of demand, and had to be looked at in relation to the other items in the balance of resources. The calculations of the excess demand gradually diminished in significance, and forecasts of price developments came to be included in the calculations.

The tendency in the past decade has been, broadly speaking, for the number of direct controls in the economy to diminish. This has led to some technical difficulties in the national budget work. As long as regulations were used to cut off a part of the excessive pressure of demand, the plans of the regulating authorities could be inserted in the calculations in these areas. Now, however, many of these items have to be determined simultaneously with other items, since they affect one another mutually. A most important example of this is imports, which have to be estimated, after liberalisation, in connection with the prognoses on internal production and demand. Another, and more topical, example are the agricultural prices, which were previously determined annually by direct regulation, but which have since 1956 been allowed to fluctuate within certain limits.

In the present situation we can say that exports, the terms of trade with other countries, investment and public consumption are determined with a certain degree of independence from each other and from the other items of the balance of resources. The national product, consumption, imports and changes in stocks, on the other hand, exercise an influence on each other. These are so intimately linked by various connections that they cannot be estimated independently apart from each other. It is clear that investments, too, considered over a period of a year, are not independent of the general economic development and should also be estimated within the system. Behind the estimates of consumption lie assumptions about incomes, taxes, prices and personal savings, which more or less are included in the general independence of the system.

The national budget work does not build on a fixed technical model of economic development. We could say that it is done by successive adjustments of the various items to one another, after various external factors of significance for their development have been taken into consideration. It is a process of trial and error. Some prognoses are worked out in fairly great detail, eg. those for exports, imports and investments. At present an attempt is being made to discuss the development of production and prices, too, in greater detail, whereas consumption is only estimated in total, without differentiating between the various types of consumption expenditure.

The possibility of making an estimate of future developments of the type represented by the Swedish national budget depends largely, of course, on the statistical material available. From a statistical point of view changes in stocks are the most fallible point in the national budget work, and prognoses in this area must at present be regarded as little more than informed guesses. When the preliminary national budget is drawn up at the end of the year no precise information is available on changes in stocks during the past year. Knowledge of the previous year's developments is of especial importance in the case of stock changes. If a considerable increase in stocks has taken place in the previous year, there can be more room for an increase of consumer and capital expenditure than if there had been no such increase in stocks. This factor plays a not unimportant role, since variations in stocks have been very considerable in several post-war years. Increases in stocks corresponding to about two per cent. of the national product have not been unusual.

Another sector worth mentioning in this connection is personal saving. Although marginal saving (i. e., the proportion that is saved out of an increase in income) has been fairly constant over the post-war period according to the calculations of the National Institute of Economic Research, there have been not insignificant variations from year to year. It is very difficult to estimate in advance these marginal fluctuations, which are of such significance for the judging of probable developments of consumption.

There is some ground for hope that these two statistical gaps will be somewhat narrowed in the future. The Board of Trade is to investigate the possibility of obtaining quarterly statistics on stocks, and an extensive study, conducted by interviews, of household savings is being made in the Institute of Economic Research.

The Budget and Actual Developments

It may be of interest to compare the figures in the national budgets with the actual developments as shown in the later statistics. Divergences between them can, however, be due to a number of different causes, so that interpretation of them is a complicated matter. Some of the most important causes will be discussed below. In the table there are shown percentage changes in the various items of the balance of resources, first according to the most recent national budgets, then as they actually occurred. The table deals with the last three years, in which the national budget adopted a more definite form of prognosis.[8]

One of the possible causes of divergences between budget and outcome is the occurrence of *unpredictable* events. Here several factors may play a part, none of which is of particular significance on its own. It may be a change in economic policy in other countries that affects export prospects, or abnormal weather conditions with consequent effects on agriculture and foreign trade. A typical case of this type occurred in the outcome of the 1950 budget. It was impossible then to foresee the outbreak of the Korean war. This led naturally enough to considerable deviations from estimates of exports and imports.

Errors in the *primary statistical material* represent another cause of divergences. A typical example of this can be found in the immediate post-war period, when the national budget figures for increases in production were very low.

[8] One reservation must be made concerning prices. The ex post figures are calculated at 1954 prices, while the budget for any given year is worked out in the prices of the previous year. Some divergences may be due to this factor.

When the calculations of the national product for these years were revised and improved, new statistics gradually appeared showing a considerably greater increase in the national product than had previously been supposed. Such mistakes can be avoided to the extent that the preliminary basic calculations for previous years can be improved. The division of the prognosis into the different sectors of the economy has certainly improved the results of the estimates of future national products.

A third cause of divergences lies in the very *caution* of the prognoses. This is an aspect of human nature which has been observed in many countries where similar work of prognostication is carried on. There is a hesitation to predict very great changes from the preceding year. It is also an apparent characteristic of the Swedish national budget work that the force of the expansion of foreign trade has frequently been underestimated, both on the export and on the import side. Mistakes in the calculation of the balance of trade, however, have not been of the same order of size. This is shown to some extent in the figures below, which show the budget and the actual outcome for the balance of payments on current account for the years 1954–56:

	Million kronor		
	1954	1955	1956
Budget	±0	−150	−440
Outcome	−170	−410	−160

The divergences may seem great, but behind these figures lie the estimates for such large items as the volume of exports and imports and developments of the terms of trade.

A fourth reason for divergences between budget and outcome lies in the *technique of prognostication* itself. It is difficult here to point to specific causes of divergences, but one example is the difficulty of foreseeing cyclical turning points. Typical of this is an underestimation of the increase in exports, investments and production in 1953, when there was an upwards turn in economic activity. Estimates of consumption, similarly, have often been unsatisfactory because of the difficulty of predicting variations in the propensity to save. On the other hand, items that are not directly affected by the general climate of economic activity, such as public consumption, are easier to estimate. Public consumption, for which statistics on plans are available, has increased fairly steadily from year to year, and the forecasts here have turned out fairly well.

We should mention again in this connection that the various items in the national budget are linked together. For one thing, there must be correspondence between the supply and demand sides. For another, as was mentioned previously, there are certain many-sided connections which cannot be expressed precisely but which lie behind the prognoses. This means that a mistake in one item of the balance of resources which is intimately connected with other items will lead to mistakes in these also. Thus a mistake in the estimation of independent items such as investments and exports can lead to wrong conclusions concerning all the other items, without involving any mistake in the technique of prognosticating these. Some Norwegian investigations suggest that divergences in the prognosis of these independent items play a large part in accounting for divergences in the others.

National budget outcome, 1954–56

[Percentages; B=Budget. RB=Revised budget. O=Outcome]

	1953-54		1954-55		1955-56		
	B	O	RB	O	B	RB	O
Supply:							
Gross national product	+3.5	+4.6	+4.4	+4.2	+3.0	+3.1	+2.6
Imports	+1.2	+14.6	+6.0	+11.0	+1.0	+1.9	+5.7
Use:							
Gross investment	+3.1	+7.4	+3.6	+1.0	+2.0	+4.1	+2.1
Exports	−2.7	+9.1	+4.0	+6.2	+2.0	+2.0	+10.1
Private consumption	+2.8	+4.4	+5.7	+3.5	+2 9	+3.2	+2.4
Public consumption	+6.1	+4.3	+4.1	+3.4	+4.2	+5.1	+4.4

It is important to stress in summing up that divergences between budget and actual developments may have several different causes. They may be due to weaknesses in the technique of prognosis and its statistical base, but they can also be due to the occurrence of unpredictable events that affect the developments. In the former case we should of course consider whether the statistical material and technique of prognosis can be improved. An investigation of the causes of divergences might give some indication of the points where improvements are most needed. In the latter case, however, divergences between budget and actual outcome do not show that the prognosis was incorrect, starting out from the conditions prevailing at the time at which it was made. The uncertainty about the future that is revealed in such cases should, however, be taken into account as an important factor in the planning and implementation of economic policy.

It should finally be pointed out that the "actual development" with which we compare the national budget figures should not be regarded simply as a 'true reality'. The outcome registered by the help of national accounting is built up from statistics with all degrees of uncertainties, and the methods used depend partly on hypotheses that cannot be verified. It must be admitted that in the case of the balance of resources prognosis and 'actual outcome' are linked by the technique of calculation.

CONCLUDING REMARKS

It is obvious that we cannot, at present, make exact forecasts one year ahead on the basis of an economic model. This is true both of the externally determined items and of the items determined internally within the model. The aim now must be to improve the methods of prognosis and the economic statistics. There are probably many tasks in this field that should yield a high marginal return. One such task is to expand the national budget method to include a more complete system of national accounts. Behind the balance of resources lie the incomes and expenditures in the different sectors of the economy, closer study of which might be rewarding.

The credit market statistics come into the picture in this connection. An attempt is at present being made in many countries to expand the national accounts to include transactions on the credit market. This should certainly be of great use for the economic discussion on the connection between real economic problems and those of the credit market. The connection between these two spheres should be able to be made clearer than it is at present.

Whatever improvements may be made in these respects, it seems unavoidable that quantitatively precise predictions of the future a year in advance, in an economy of the Swedish type, should be subject to a considerable margin of error. The quantitatively precise estimates should be used at first hand to serve as a basis for the general economic discussion.

This leads us on to the question of time. A year is rather a long period to survey when drawing up a national budget. The reason for the choice of a period of a year is that many plans in the economy are drawn up for this period. This is true of the plans of the local authorities and of the state, and also to a certain extent of investment plans within industry. Also wage agreements are reached for a period of at least a year. Thus there are many data that point to the decision to draw up a national budget for one year forward. Besides, it is important from the point of view of economic policy that the national budget should cover a period of a year. The national budget prognosis should really rather cover 1½ years. The state budget and fiscal policy are largely fixed for the coming state budget year, which begins half way through the calendar year.

Actually the course of events in many parts of the economy is bound by plans for considerably longer periods than one year. The lack of coordinating study of plans and tendencies over a longer period can easily lead to a far too one-sided concentration of economic discussion on short term problems. Day to day economic decisions, on the political plane as well as within a firm, often lay the foundations of future economic development over a longer period. The recently published investigation into long term tendencies of the Swedish economy shows how many long term economic problems require solution in the near future. In the discussion on the investigation into long term tendencies for the period 1955–60 it was clear that the idea of continuous long term economic planning was acceptable to many of the parties concerned. The need for a link between the annual national budget and a continuous long term plan is obvious.

With regard to the uncertainty in the prognoses we may also discuss the form in which the national budget should be presented. As we have said before, considering the extent of the area now covered by the state budget and the importance of the part it plays as an instrument of economic policy, it has to be presented against the background of an estimate of the probable course of the general economic development. Whether this estimate should be presented verbally or, as in the national budget, in figures, is open to discussion. Another less ambitious method would be to present several alternative courses of development, although this might sometimes be misleading. The fact that the methods of prognosis, their statistical base and the development itself are not such as would enable exact prognoses to be made does not remove the need for a precise quantitative account of the potential economic development according to the methods included in the technique of national budgeting.

We shall not attempt to come to any conclusions as to what significance the national budget work has had for the planning of economic policy in Sweden. It should merely be stressed that the national budgets have in any case been of pedagogical value. They have encouraged people to look at real economic problems as a whole, from the point of view of the balance of resources. It seems to be important for reasoning on economic subjects that problems should be thought out within the frame of a general economic system, and the work on national accounting will gradually open up further pedagogical possibilities.

SWITZERLAND

CENTRAL BANKING IN SWITZERLAND*

1. Historical Setting

The Schweizerische Nationalbank (Swiss National Bank) was established in 1907, with the sole right of note issue, after nearly 20 years of political dispute as to the legal form of the Bank and its location. As might be expected in a federal state, Switzerland "decentralized" the central bank, by requiring that the two departments concerned mainly with securities and foreign exchange matters be located in Zurich, the capital market and foreign exchange center, while the department concerned with the note issue and Federal Government relations was required to be located in Berne, the seat of the Government. The Bank's legal and administrative offices are located in Berne, and the office of the Board of Directors is located in Zurich. The Bank maintains eight branches and three agencies in the major cities and towns of Switzerland.

The main duties of the Bank, according to the revised national bank law of 1953, are to supervise the money circulation, regulate currency and credit policies for the benefit of the country, facilitate domestic payments, and advise the Federal Government on currency matters.

2. Ownership and Control of the Central Banking Institution

The Swiss National Bank is a joint stock company with an authorized capital of 50 million francs, only half of which has been paid in. At the end of 1956, 57 per cent of the capital was held by the cantons and cantonal banks, while the remainder was held by a large number of private shareholders.

A Bank Council of 40 members, 15 elected by the stockholders and 25 by the Federal Council (the Swiss Cabinet), is the organization with general supervisory control of the Bank. The Bank Council is required to have adequate representation of commerce, industry, and agriculture. An Executive Committee of 10 members, elected by the Bank Council, is responsible for the close supervision of the management, and it must meet with the latter group at least once a month. A Board of Directors consisting of three members appointed by the Federal Council, after recommendation by the Bank Council, is the responsible authority for the day-to-day running of the central bank. Since the Federal Government is responsible for appointing or electing the majority of the supervising and controlling organizations of the Bank, it is to be expected that the Government exercises considerable influence in the decisions and management of the central bank.

*Prepared at the request of the Joint Economic Committee by the Division of International Finance, Board of Governors of the Federal Reserve System, Washington, D. C.

3. Relation of the Central Bank to the Government

As indicated, the influence of the Government with the central bank is considerable, and from time to time the Federal Council has prescribed monetary policies for the Bank to follow. The Bank has permissive power to purchase both Federal and cantonal Government securities for the temporary investment of funds, and it "cooperates" in the placing of new Federal and cantonal funds. The Bank is required to re-discount acceptances for financing strategic stocks at the minimum applicable rate.

4. Relation of the Central Bank to the Commercial Banks

The Swiss National Bank is not prohibited from dealing with financial institutions other than banks of deposit, but virtually all of its business, other than that with the Federal and cantonal Governments, is with banks of deposit.

5. Power of the Central Bank Over the Instruments of Monetary Policy

Although the central bank has power to vary the rates on re-discounts and advances, the re-discount rate has been changed only once in over 20 years (it was changed in May 1957); re-discounting and resort to advances figure little in operations of Swiss commercial banks, and they rarely go to the Swiss National Bank in order to improve their liquidity. The Bank does not have power to adjust reserve ratios—such a power is believed to be unconstitutional—and in order to utilize this tool of monetary policy the central bank has at times entered into voluntary agreements with the banks for holding certain minimum reserves in blocked accounts at the Bank. Open market operations are not a significant instrument of central bank policy in Switzerland.

The Federal Banking Law does, however, prescribe liquidity requirements for all banks, but the banks are under no penalty if they are temporarily deficient. These requirements are quite high, and they are based upon a rather complicated formula involving various ratios of liquid assets to liabilities. The liquidity requirements are supervised by the Banking Commission, a group appointed by the Federal Council, and independent of both the Swiss National Bank and the Treasury.

In the main, the central bank influences the Swiss economy through its power to regulate the foreign exchange market (including control over capital movements), which bears importantly on Swiss economic life.

6. Channels or Sources Supplying Business Capital

The Swiss National Bank cannot finance capital development. The commercial banks of Switzerland are "department store" banks, meaning that they engage in all types of banking business. Small businesses which are members of the credit unions (Raiffeisen Banks), a well-developed and widespread movement in Switzerland, are able to obtain development financing through their local organizations.

STRUCTURE OF THE SWISS CREDIT SYSTEM*

The Swiss National Bank, in accordance with the basic principles observed in the country with regard to economic freedom and in view of the country's financial situation (the size of its monetary reserves, its budget surpluses, the large volume of savings, etc.), is of the opinion that, in principle, healthy market forces must be allowed to exert their influence freely. The National Bank has the power to change the Bank rate but has not used it since 1936. It has the authority to operate in the open market, but its portfolio of government securities is negligible. When, at times during these post-war years, the Swiss National Bank has wished directly to influence the monetary situation, it has had to do so rather by means of sales or purchases of gold and foreign exchange—and in this field its efforts have been and are being actively supported by parallel action on the part of the Federal authorities. It seems, however, that the method most frequently used by the central bank is the promotion of interbank gentlemen's agreements in line with its policy.

As to the protection of the banks' creditors, a Federal law lays down rules regarding the relationship to be maintained between the banks' own capital and their total liabilities and between their liquid assets and their short-term liabilities.

The following table, giving the figures for the main items in the balance sheets of the various banking groups in Switzerland, shows the relative importance of each group, the kind of funds received and the principal forms of lending practised.

*Bank for International Settlements, Monetary and Economic Department, "Credit and Its Cost" (CB 268), Basle, Switzerland, January 1957.

Main items of the balance sheets of Swiss credit institutions at the end of 1955

[In millions of Swiss francs]

Groups of institutions	Liabilities: Deposits[1]: Sight	Liabilities: Deposits[1]: Total[2]	Liabilities: Own funds (capital plus reserves)	Total balance sheet	Assets: Bills and advances[3]	Assets: Mortgage loans	Assets: Securities and participations
Primarily commercial banking:							
5 big banks	4,560	7,930	800	10,490	5,930	860	1,010
Mixed banking:							
28 cantonal banks	1,300	11,400	1,080	13,700	3,700	8,000	1,220
166 local and other banks	1,090	2,860	360	3,850	1,790	950	400
Total	2,390	14,260	1,440	17,550	5,490	8,950	1,620
Primarily long-term banking:							
90 local mortgage banks	240	3,470	340	4,500	760	3,300	250
117 savings banks	70	2,410	180	2,750	340	1,980	300
1,020 Raiffeisen banks	140	1,300	70	1,400	240	900	10
Total	450	7,180	590	8,650	1,340	6,180	560
Grand total	7,400	29,270	2,830	36,690	12,760	15,990	3,190

[1] Excluding interbank deposits.
[2] Including Kassenobligationen and own bonds issued, but excluding funds received from central organisations of cantonal and mortgage banks.
[3] Including those to Swiss public authorities, which represent some 10 per cent. of the balance-sheet total or the whole banking system.

Although it is true that Swiss banking institutions practise "mixed banking" and that the great majority of banks receive savings deposits and grant almost all sorts of credit, it is nevertheless possible to describe the "five big banks" as commercial banks. The demand deposits held by the banks in this group clearly exceed their deposits at longer term, and they engage predominantly in short-term lending in its various forms; they therefore maintain high liquidity ratios.

Commercial banking business is carried on also by the cantonal banks and the local banks. The 28 cantonal banks form the most important banking group in Switzerland, though not in terms of turnover, that of the big banks being considerably larger, at least from the point of view of their balance-sheet totals. Mortgage loans represent about 60 per cent. of their total assets, while sight deposits constitute little more than one-tenth of total liabilities. There are 166 local and other banks which do mixed banking business, though for them commercial banking proper is relatively more important than is the case with the cantonal banks.

A third group, dealing almost exclusively in the long-term sector, includes the mortgage, savings and Raiffeisen banks. All these institutions receive the bulk of their resources in the form of savings deposits and—in the case of the mortgage and Raiffeisen banks—of subscriptions to Kassenobligationen (a kind of savings certificate issued by the banks, with currency periods of up to eight years) and supply credit mostly in the form of mortgage loans to all kinds of borrowers.

There are also 30 financial corporations, whose combined balance sheets added up at the end of 1955 to Sw.fcs 720 million, 65 per cent. of this amount being accounted for by their own funds (capital and reserves). They invest mostly in capital-market securities (over 60 per cent. of which are foreign).

The postal-cheque and giro system at the end of 1955 had some Sw.fcs 1.4 milliard deposited with it by about a quarter of a million customers. The turnover of these accounts in that year exceded Sw.fcs 137 milliard, and of this sum over four-fifths took the form of cashless transfers.

The Swiss bankers have a variety of professional organisations through which they co-operate by concluding agreements regarding the terms and conditions which are to govern their activities, by forming issuing syndicates, etc.

Since 1936 the official discount rate of the Swiss National Bank has been 1½ per cent. and the lombard rate 2½ per cent. The various credit institutions, however, do not normally have recourse to the central bank, the market situation being sufficiently easy for them to be able to obtain all the funds they need. Terms and charges are fixed by interbank agreements (often local). Interest on deposits is allowed at the following rates:

	Per cent.
Sight deposits (minimum rate)	½
Time deposits (minimum rates)	1–1¾
Savings deposits (average rates allowed)	2–2¾

In November 1956 the average rate paid by cantonal banks was 2.33 per cent. on savings deposits and 3.13 per cent. on Kassenobligationen. No interest is paid on deposits in foreign currencies (in fact, a commission is charged).

The Swiss banks discount three-month trade bills of the very first grade at the Bank rate, i. e., 1½ per cent., but the charge for the discounting of current commercial bills may be as high as 4½ per cent. Secured advances cost the borrower between 4 and 5 per cent., privilege rates of 1½ and 3 per cent., respectively, being applied in the case of advances connected with the maintenance of compulsory commodity stocks and with the cession of clearing credits. The charges for overdrafts are 5½ to 6 per cent. First-mortgage loans on real estate, which constitute nearly one-half of the assets of Swiss credit institutions, are granted (towards the end of 1956) at 3½ to 3¾ per cent., and second-mortgage loans—mostly extended by non-bank institutional investors—cost between 3¾ and 4 per cent. The banks charge 3¾ per cent. on industrial loans secured by mortgage, while the cost to customers of medium-term loans of various kinds (including import and export credits) varies between 3½ and 4½ per cent.

The money market in November 1956 quoted a rate of 1½ per cent. (for call money, etc.) and the average yield of government bonds on the long-term market during the same month was nearly 3¼ per cent.

Domestic industrial bonds have been issued in 1956 at nominal rates of between 3 and 4 per cent. and foreign loans mostly at 4 to 4½ per cent. The overall cost to the foreign borrower is, naturally, higher: a 4½ per cent. issue in October 1955, placed at an effective overall cost of 6¼ per cent., was described by the borrowing corporation as being somewhat cheaper than some other similar issues on the Swiss market in 1955.

Switzerland: Main rates paid and charged by credit institutions (including commission, etc.)

[In percentages]

Items	Central bank	Commercial banks	Other credit institutions
Rates paid on—			
Sight deposits		½ [1]	
Time and savings deposits		1¼ to 2¾	Up to 3½.
Kassenobligationen		Up to 3¼	Up to 3½.
Rates charged on—			
Trade bills (discounting)	1½	1½ to 4½	
Advances	2½	4 to 5	
Overdrafts		5½ to 6	
Medium-term loans		3½ to 4½	
Mortgage loans		3½ to 3¾	3½ to 3¾.

[1] Minimum rate paid.

BANKING IN SWITZERLAND*

R. S. Sayers

Switzerland is a tiny country, with less than five million inhabitants. It has five cities with populations over 100,000—Berne (the political capital of the federation), Zurich, Basle, Geneva, and Lausanne, the largest being Zurich, with 410,000. The position of Switzerland in the financial world is, however, out of all proportion to these figures; Zurich, Basle and Geneva are among the leading international financial centres of Europe. This high standing is due in part to Switzerland's neutrality in a half-century of international upheavals. More directly, it is due to the stability of Swiss money, an island of dependability surrounded by countries whose currencies have repeatedly collapsed. With reasonably strong financial institutions Switzerland could hardly have failed to gain ground in international finance.

The purpose of this article is to survey these financial institutions; as they rival those of England in the international respect they command, a view through English eyes may have particular interest.[1]

I

At the centre of the system is the Swiss National Bank, an avowedly public institution comparable to the Bank of England in outlook if not in powers. The structure of commercial banking is much more complex in Switzerland than in England: the bulk of the banking of the normal English kind is in the hands of five big banks, but these hold only about 30 per cent of the total published banking resources, the remainder being spread over the Cantonal banks, mortgage and other local banks, and Raiffeisen banks. Among the banks of purely local importance are three Italian banks operating in the Ticino. Outside the published statistics there are the Private Banks, which are the oldest of all, going back well into the 19th and even into the 18th centuries. The Cantonal, mortgage and other local banks are concerned largely with the canalisation of thrift into long-term investment in property, but most of them have also an appreciable amount of ordinary banking business. The Raiffeisen banks are co-operative concerns, each confining its operations within its own parish (an important unit in Swiss affairs) and depending upon voluntary work and upon mutual knowledge and trust among neighbours.

The big banks are, in order of size, the Swiss Bank Corporation, Credit Suisse, the Union Bank of Switzerland, the Banque Populaire Suisse and Leu and Company. The last two of these five are very much smaller than the other three, which are frequently alone referred to as the big Swiss banks. Leu and Company is a particularly small

*Banca Nazionale del Lavoro Quarterly Review, vol. VII, No. 28–29, January–June 1954, pp. 23–31.

[1] The writer has had assistance from Mr. S. Wainwright and has had the advantage of consultation with several eminent Swiss bankers.

concern, mainly confined to Zurich. The Swiss Bank Corporation has its Head Office in Basle; three of the others are in Zurich (the two cities are only one hour's journey apart, and relations between offices in the two cities can be close and continuous); the Banque Populaire Suisse has its Head Office in Berne. All these banks are free to open branches and agencies anywhere in Switzerland; they in fact do so, and have between them 182 branches and agencies, affording reasonable accessibility for all parts of the country. The Swiss Bank Corporation and the Credit Suisse both have affiliated companies in Montreal and offices in New York; the Swiss Bank Corporation also has an office in London.

The Cantonal banks—there are 27 of them—are as a group rather bigger in total resources than are the five "big banks" as a group. They are also very prominent to the traveller's eye; but they are less active in banking of the English type, their business consisting much more of the collection of savings on the one side and lending on mortgage on the other side of the balance sheet. Each of these Cantonal banks is restricted to operation within the boundaries of its Canton; within these limits, they may have branches, agencies or deposit counters freely. In fact they have, in addition to their Head Offices, 79 branches and nearly a thousand agencies and deposit counters. 23 of these 27 banks are government banks and their liabilities to depositors are therefore guaranteed by the respective Cantonal Governments; others are associated in other ways with their Cantonal Governments. These conditions give them a certain prestige among the people, whose cantonal loyalties are strong. Their privileged position in this and other respects (unlike the big banks, most of the Cantonal banks are exempt from Cantonal taxation) are the subject of some envy on the part of the big banks, who feel that they are subject to "unfair" competition. There are, of course, some circumstances pulling in the opposite direction: the Swiss citizen, who attaches the highest importance to secrecy, sometimes feels his business secrets safer with the independent commercial banks than with these Cantonal banks with their governmental connections, although there is in fact no difference in this respect.

The "private banks" stand apart from the main structure of Swiss banking, though among them are quite large and wealthy concerns with a large international business. Unlike the "big banks," these private banks have unlimited liability. They publish no accounts, though they submit confidential balance sheets to the National Bank. In their age and in the origination of their business they may be compared with the merchant banks of the City of London; their business and their customers of today are, however, rather different. They specialise in an essentially personal, family business, their customers generally being wealthy people in Switzerland or neighbouring countries, or indeed from anywhere in the world. They act particularly in the administration of estates, as investment brokers and advisers and in foreign exchange business. They are most prominent in Geneva, which traditionally had close associations with French finance and has thriven on the untrustworthiness of the French franc since 1914. They, and the others in Zurich and Basle, depend completely upon their world reputation for secrecy and attention to the interests of wealthy men of all nations.

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II

Besides these institutions, all of which are banks in the sense that they accept deposits and make loans of some kind or other, there is the Postal Cheque System, run by the State in connection with the Post Office. This provides a medium of payment, and incidentally to this service holds deposits by people wishing to use it for making payments. It does not act as an ordinary lending banker, its assets consisting of government obligations of various kinds. It is convenient, efficient, and extremely cheap, and is therefore widely used for all but the smallest payments; the availability of this service inevitably limits the scope for banking of the English type, where the extent of banking resources is largely dependent upon the use of current accounts for a broad range of payments. Swiss bankers are keenly aware of the importance of this service in limiting their own scope, and they have in recent years made great efforts to provide comparable service, in the hope of attracting more deposits to themselves.

Notes—issued only by the National Bank—are, apart from coin, the sole means of payment used by many people whose only resort to banks is in placing their small savings in Cantonal or local savings banks. The notes are also used by all classes for the general run of everyday small transactions, including much retail trade, though the convenient postal cheque is sometimes used for transactions which in England are still largely settled with notes and coin. Even after allowing for this qualification, however, the use of notes is so much more common in Switzerland than in the Anglo-Saxon countries that the proportion of notes to National Income is in Switzerland about double what it is in the U. S. A. and the United Kingdom.

As the postal cheque and the note are used much in Switzerland when an ordinary banking account would be used in England, current accounts with the big banks and the Cantonal banks are mainly kept by the large and medium-size business firms and by the wealthier individuals. One of the big banks claims that many people with only middling or small resources do keep current accounts with it; but more commonly such people keep only deposit or savings accounts at the commercial banks, and draw on these accounts to replenish their working balances with the postal cheque system. The deposit and savings accounts at both the big banks and the Cantonal banks are elaborately differentiated—an elaboration that has no parallel in England. Time deposits are fixed for periods varying from three to twelve months; they include accounts of quite large concerns as well as individuals, and represent temporarily unemployed business funds or accumulations awaiting favourable investment opportunities. Much more important in all but the biggest banks are savings deposits; these are also of great social importance, ownership being very widely spread among the population. The smaller balances carry special legal protection, having a prior claim in the event of the bank's liquidation. The smaller balances also carry a higher rate of interest (2½ per cent at present) than the excess balance above a certain amount. The turnover of these deposits is very slow: the banker expects the customer to leave the balance undisturbed except for such calls as the education of children, provisions for old age, etc. There are also deposit books for small savings deposits, carrying a rather lower rate of interest; from these only limited withdrawals may be made in any one month.

An important feature of the Swiss system is the cash bond (bon de caisse), having no parallel in England, but now being developed elsewhere in Continental Europe. This is in essence a long-term fixed deposit of a round sum (generally 500 francs or a multiple thereof). The sum is repayable after 3, 4, 5, or exceptionally 7 or 8 years;[2] meanwhile it bears interest, payable on half-yearly coupons, at rates somewhat higher than those paid on any of the classes of deposit mentioned above. A customer holding one of these bonds and needing the cash before maturity can sometimes sell the bond to the issuing bank, but more generally the bank concerned (especially if a Cantonal bank) will lend up to 95 per cent of the value of the bond, at a relatively high rate of interest, and without enquiring into the origin of the customer's need. These bonds have tended to decline in relative importance in recent years, but still bulk large in the balance sheets of many banks; in the Cantonal banks, there are still about 20 per cent of the total liabilities.

III

In the employment of their resources, contrasts between the various classes of banks reflect the contrast on the Liabilities side of their balance sheets. The big commercial banks, more than half of whose liabilities are payable on demand, aim at a high degree of liquidity. They hold about 10 per cent in various kinds of cash, and another 30 per cent in bills of exchange and other highly liquid items. 25 to 30 per cent is represented by advances to customers on current account, and these advances are nearly all for purely short-term purposes. Their loans on mortgage are only 5 or 6 per cent of their total assets. On the other hand, the Cantonal and local banks, with sight liabilities as little as 10 per cent of the total, have cash and all other liquid assets totalling less than this. Their current account advances to customers are not often much more than 10 per cent, but they generally reckon to have about 60 per cent of their resources in mortgages.

The emphasis laid in the big banks upon short-term lending has strengthened considerably during the last quarter of a century. Traditionally some of these banks—and more particularly others which they absorbed—were deeply involved in financing some of the great industrial developments and public utilities. But in difficult times—not least in those of the 1930's—there were some badly-burnt fingers, and these banks now reckon to have less than 10 per cent of their total resources in any sense "locked up" in long-term finance; they have very little indeed in the way of actual "participations" in industrial and commercial concerns. They are, indeed, more English than the English in their insistence that a commercial banker's duty is to stick to the very short-term proposition. They do hold a small proportion of their resources in mortgages, but much of this business is purely temporary pending a customer's arrangements elsewhere for permanent finance. Occasionally also a big bank will lend on mortgage to a customer of long standing who expresses a preference for keeping all his business with the one bank. It is in these odd ways

[2] Some smaller banks issue bonds running up to 10 years.

that the big banks come to hold their small percentage of mortgages; their general policy is to leave mortgage business to the Cantonal and savings banks.

Though the big Swiss banks are like the English banks in their general avoidance of mortgage business, there is nevertheless a sharp contrast between the two countries in the placing of most of this business. In England a very large part of the mortgage business—especially on house property—is in the hands of "building societies," whose main work indeed this is; the insurance companies also hold large amounts, while much is still privately placed by solicitors with individuals. In Switzerland no less than half the total mortgage business is with the banks, more than half of this half being held by the Cantonal banks, the remainder being largely with local savings banks and similar institutions. The form of mortgage also is rather different in Switzerland from the forms prevalent in England. In Switzerland generally no term is fixed for the loan, but it is callable at six months' notice on either side.

All the banks, and particularly the Cantonal banks, go to considerable trouble for the sake of small borrowers. The "Kleinkredit" or "Little Credit" is a loan in a class by itself; in providing this service, the banks regard themselves as performing a public duty, from which the direct profit is clearly negative. The Kleinkredit bears a relatively low interest charge—usually only 4 per cent—and it frequently causes an amount of work out of all proportion to its size. In making these loans, the banks do not restrict business to self-liquidating transactions; they lend to small firms and individuals for long-term purposes such as the extension of industrial buildings or the purchase of new machinery, and they look for repayment over a term of years, varying according to the case.

The existence of these special services for the small business man may perhaps be taken as indicative of the spirit of Swiss banking. The services for the small man have always been the special concern of the Cantonal banks, which are avowedly public institutions. Their existence, their energy, and their hold upon the strong local loyalties of the people combine with the availability of a cheap and efficient postal cheque system to limit severely the scope for the big commercial banks. To make a place for themselves these great commercial institutions have to compete keenly for business; they have to be up early in the morning, both literally and figuratively.[8] The spirit of competition is very lively through the whole system: the big banks compete keenly with each other, and with the Cantonal banks. Because the Cantonal banks provide special loan facilities for small men, the big banks act similarly, and have come to think of this service as expressing "the spirit of the bank." They take the business whenever they can get it, regardless of its low yield and high cost—they take a long view, knowing that some small business men of today will be among the giants of tomorrow or the day after, and always knowing that one piece of business can easily bring other business, perhaps more profitable business, in its train.

In their relations with bigger customers, the banks show the sharpness of competition among themselves in a number of ways. They feel compelled, for example, to defer to the customer's secretiveness

[8] The Swiss banker reckons in summer to be in his office at 7:30 in the morning.

about his precise financial position, and do not even feel that they can insist on the customer's confining his main banking business to a single bank. The Swiss business man is apt to object to a request for his balance sheet; and the bank will then have to tread warily, lest the customer should transfer his account to a competitor. For similar reasons the banks do not exchange credit information about business firms with the freedom to which London is accustomed. These conditions—and the use of the postal cheque service—all tend to leave the banks less knowledgeable than are English banks about many of their customers, and this has an important bearing on their habits in making advances. The Swiss banker, like his English parallel, knows that his judgement of borrowers is more important than any formal security he can take, but, as his knowledge of his customer is apt to be limited, he more often feels compelled to insist upon formal security. Towards customers of long standing, whose position is well known to the bank, the bankers naturally adopt an altogether more flexible attitude: this again is assured by the keenness of competition between the bankers. For these established customers the availability of bank loans—the terms, the flexibility, and the purposes for which they are granted—is in all respects comparable at the big Swiss banks with what happens in the English banks.

This business of lending to customers, while most important in the big banks which have about one-third of their resources in this class of assets, is undertaken by all the banks, even the Cantonal banks using about one-fifth of their funds in this way. Bills, on the other hand, are very largely concentrated in the hands of the big banks, whose balance sheets show about 22 per cent of the assets under this heading. Traditionally these bills were largely bills of exchange arising in the course of foreign trade and other large trading business, and as such business falls very largely into the hands of the big banks, these banks have been able to obtain bills most easily and have always held most of them. During the last quarter of a century there has been, in Switzerland as in England, a great decline in the use of bills of exchange. Their place has been partly taken by Treasury Bills, which now form about one-third of the total bill portfolios of the banks. An innovation of the 1939–45 war, and again important since the Korean War, is the special three months' bill used to finance compulsory holdings of raw materials by Swiss industry. 90 per cent of these bills are guaranteed by the Swiss Confederation and are discounted by the banks at a privilege rate of 1½ per cent; the remaining 10 per cent are discounted at ordinary market rates. These special bills are all automatically eligible for rediscount at the National Bank, whereas other commercial paper is subject to the discretion of the National Bank (as explained below).

The Investments of the banks, of all classes, are relatively much smaller balance-sheet items than has become customary in English banking. The big banks show only 12 to 14 per cent of their assets in this class, which includes not only holdings of government bonds, Federal railway bonds, etc. but also their participations in their subsidiary investment companies and other small items of this kind. The Swiss banker does not regard these bonds as a really attractive banking security, and generally confines himself to those with fairly short lives. Ordinarily he will not hold any bonds with more than five years to run; exceptionally his investment manager may have discretion to "go rather longer" in small amounts, but in no case would he take paper longer than 15 years from maturity.

Besides their main business of receiving deposits and making loans, the big Swiss banks all reckon to provide quite substantial other services for their customers. These include every kind of foreign exchange business, which is probably more easily transacted in Switzerland than anywhere else in the world—at any rate by the smaller firms and individuals. The banks also serve their customers as advisers and brokers in all investment matters—they are all members of the Stock Exchanges (as is common in other Continental countries, in contrast to English custom). In connection with all these ancillary functions the big banks have elaborate information services which they are eager to offer to customers.

In one important ancillary function the banks depart from their usual competitiveness. This is in the making of capital issues. There are no specialist "Issuing Houses" comparable to the merchant bankers of London, and all public issues of capital are in the hands of the banks, organised in two syndicates—one including all the big banks and the other the Cantonal banks. In all large domestic issues both these syndicates normally participate, and the business of selling and underwriting the securities is shared out among the participating banks in each syndicate according to proportions applicable to all issues over a considerable period. Issues for foreign borrowers (including in recent years the International Bank for Reconstruction and Development) are handled by the syndicate of the big banks only. The degree of co-operation with which this business is handled is particularly notable: if one member of the syndicate does not like a proposed issue, the other members reject it rather than proceed without participation by the whole syndicate.

The banks look to such ancillary functions as this handling of capital issues and dealings in foreign exchange for an appreciable part of their gross profits. In the main, however, they must depend upon the margin between the interest they pay and the interest they charge. The high liquidity of the system since the war has made the whole range of interest rates very low. The official Bank Rate stands at 1½ per cent, but is ineffective. On government bonds yields range from 1¾ on 4-years' bonds to about 2½ on the long-term bonds. Rates charged on ordinary bank advances are not published, but are understood to be in the range 3 to 5 per cent, most of the better grades earning appreciably less than the current English rates of 4, 4½ or 5 per cent. On mortgages 3½ is the usual rate. On the other side of the account, time deposits of various classes mostly carry 2 to 2½ per cent; in 1952 42 per cent of all "Savings Deposits" were at 2½ per cent. Cash Bonds carry 2½ to 3½, according to length of life. In these conditions all classes of banks have been enjoying rising profits during postwar years; the big banks have roughly doubled their net profits since the end of the war, and have been able to raise their dividends substantially.

IV

The most important restrictions imposed upon the commercial banks are those embodied in the Banking Law of 1934. This resulted from the difficulties of the early thirties, and was not inspired by the intention to subject the commercial banks to control by the central bank but was designed to maintain a high degree of banking liquidity for the protection of the depositors. All liabilities due at sight or within one month are for this purpose classed as Short-Term Liabilities, and against these liabilities the banks (of all classes, including the private banks) are obliged to hold cash and highly liquid assets in certain minimum proportions. The required percentages depend upon the proportions which the banks' Short-Term Liabilities bear to their total liabilities, the effect being that the required percentages are lower for Savings Banks and suchlike and higher for the big banks in which sight deposits are much more important. These liquidity requirements may be set out in tabular form:

[In percentage]

Stage	Of total liabilities short-term liabilities are—	Of the amount of short-term liabilities there must be held—	
		In cash	In cash plus highly liquid assets
I	Up to 15	2.5	25
II	15 to 20	3	30
III	20 to 25	4	40
IV	Over 25	5	50

These "stages" are applied to all banks: that is to say, a bank with total liabilities 100, of which say 40 are short-term, is required to hold in cash 2.5% of 15, plus 3% of 5, plus 4% of 5, plus 5% of 15 (15 being the excess of 40 over 25).

While it is important to note that these liquidity requirements were imposed for the protection of depositors, and in reflection of the view that a deposit bank's liquidity should be higher than a savings bank's liquidity, the requirements could be made to serve the purpose of the central bank in restraining inflationary developments. There has not been, so far, any attempt to control the system in this way; indeed the banks have for some years been highly liquid and the central bank, unable to absorb by open market operations this surplus liquidity, has not been in a position to force the commercial banks to limit the expansion of credit. Nevertheless, the existence of these liquidity requirements might in some circumstances be an important restraining factor in the whole system, besides serving their original purpose of restraining an individual bank from tying its resources unduly in illiquid uses.

The Banking Act also lays down, for banks other than Private Banks, certain requirements for capital, in relation to total liabilities, and for the allocation of some profits to the accumulation of reserves until these have become reasonably strong. There are other requirements ancillary to these various provisions: for example, the form of balance sheet is stipulated, and arrangements whereby the National Bank is provided with this information on the position of all banks, including the Private Banks whose balance sheets are not published. There are similarly provisions for auditing by independent auditors, in addition to the usual internal auditing. Finally the Act established a *Banking Commission* of five members (appointed by the Government) whose duty it is to receive the auditors' reports and in this and other ways to ensure that the liquidity and other requirements of the Act are being observed by every bank.

The central bank is the Swiss National Bank. It is a shareholders' bank; 55 per cent of the shares are held by the Cantonal Governments and Cantonal Banks and the remainder is widely distributed among private holders. The dividend it pays is limited and certain allocations to reserve are prescribed by law. In addition, it pays to the Cantonal Governments 80 cents a year for each inhabitant of the Canton (the total payment jumps every ten years when the payment is adjusted to the latest Census returns); this payment originated as compensation to the Cantons when their note-issue was replaced by the monopoly issue of the National Bank.

The government of the National Bank is a complex organisation, at least in appearance—probably the reality is simple enough. The Bank Council is a large body of representatives from all parts of the country as well as representatives of various economic activities. This Council elects eight members who, with the President and the Vice-President, form the Executive Committee. The Board of Management consists of the President, the Vice-President and one other, all of them appointed for terms of six years by the federal Government acting with advice from the Bank Council. This Board of Management is the active day-to-day administrative body of the Bank. Meetings of the full Bank Council are held quarterly and afford to the Bank's management some opportunity to ensure that the Bank's policy is understood and appreciated. Even more important from the point of view of public relations is the President's speech at the annual meeting of the Bank's shareholders; it is on this occasion that the President makes the official views of the Bank known to the whole country. The Bank enjoys substantial freedom from government interference, but in these meetings and in other ways it has to be careful to secure genuine public support for its actions. It has to make an Annual Report to the federal government, which has the right to (and sometimes does) return the Report to the Bank for amendment.

The National Bank is unusual in having two Head Offices, one in Berne and the other in Zurich. This division is not to be comparated with the twelve Federal Reserve Banks of the U. S. A.; it is rather as if the Bank of England divided its main business between two offices, one in the City of London and one at Westminster. At Zurich matters of general policy and most actual banking functions are covered, while the Berne office takes care of the government account, the note-issue, the handling of gold, and central bookkeeping. There are also 8 branches, and 15 agencies. A Canton in which there is no branch has the right to demand an agency within its area.

The bank has the monopoly of the note issue, and its notes are full legal tender. Against these notes the bank is required to hold at least 40 per cent in gold, and the remainder in bills, including both Treasury and commercial bills and, under recent legislation, certain short-term bonds. In fact since 1931 the gold reserve has always been above 100 per cent of the note issue. In appearance these arrangements contrast sharply with those in England, where the gold reserve has long since ceased to be related in any way to the note issue, and is now much less in value than the note circulation. In fact, however, the Swiss like the English authorities relate their gold reserve to the international liabilities and balance of payments; foreign deposits in Swiss banks are large and the present gold reserve is not excessive in relation to these liabilities.

The Bank acts in the normal central banking way as banker to the other banks. It receives deposits from them, on which they work for clearing purposes and for keeping themselves sufficiently but no more than sufficiently provided with tillmoney. It is empowered to rediscount bills maturing within three month and bearing two good signatures, and to grant interest-bearing loans against suitable collateral (Lombard advances). These powers enable it to act, if required, as lender of last resort, and it is clearly understood that it would so act whenever called upon to prevent a widespread financial collapse, although it would not feel obliged to intervene to protect a particular bank from the consequences of its own ill-management.

In law the National Bank is fully empowered to act as banker for ordinary (nonbanker) customers, and it does have some private accounts. It is not allowed to pay interest on any non-governmental accounts, nor does it compete in any other way for ordinary banking business. In this matter it acts in much the same way as the Bank of England, whose private banking business is a relic of earlier circumstances, a relic which the Bank seeks rather to diminish than to expand.

As banker to the federal government the National Bank holds considerable balances, on which it has power to pay interest. In lending to the government, however, it has hitherto been unusually circumscribed: it was allowed to purchase interest-bearing bearer obligations of the federal government, the Cantons and foreign governments but only for the temporary investment of funds. Most authorities on central banking would consider this restriction of the National Bank as a serious deficiency in its power as a central bank. The Bank has hitherto, because of this lack of a portfolio of government securities, been able to do little to restrict inflationary tendencies set up by the abnormally high liquidity of the Swiss banking system in recent years, a liquidity created largely by the influx of foreign deposits, a peculiarly dangerous base on which to erect an expansion of bank credit.

One asset the National Bank has, however, held in abundance—gold. The Bank has been able to secure substantially the same result as follows a sale of government securities by selling gold to the general public. It did for a short period sell gold, in significant quantities, but sales have for some time been suspended although the system remains dangerously liquid. The National Bank's discount rate has remained since 1936 at 1½ per cent, but even at this low rate it is completely ineffective, as the commercial banks are highly liquid and there are not even temporary cash shortages (very important as a source of the Bank of England's power) to force the banks to borrow from the National Bank.

In this situation of abnormal liquidity, inflationary conditions in the outside world and unduly restricted central banking power, the Swiss National Bank has had to make the most of its undefined but very important powers of advice and influence. As the government's banker it is constantly consulted on all questions of government debt management, and this naturally brings with it much other consultation—by commercial as well as official parties—on capital market operations. Its permission has to be obtained for all large foreign loans. Another important source of influence is the system whereby bills about to be discounted in the market are referred to the National Bank for certification of their "eligibility" for rediscount at the National Bank. Although the Bank's power of actually operating as lender of last resort has, through circumstances, fallen into disuse, bankers continue to act as though it might come into operation at any moment, and therefore give preferential terms to eligible paper, provided that this eligibility has been duly certified. Constant reference of this paper to the National Bank gives it opportunity for judging whether business is becoming unduly speculative, and for discouraging developments in undesired directions. In these circumstances the commercial banks have easily got into the habit of individually consulting the National Bank.

In one matter the National Bank has felt itself able to go beyond advice to individual banks, and has organised general agreement to restrict certain business. In the abundant-money years after the war, competition among the banks led to extraordinarily easy terms for mortgage borrowers. Traditionally a Swiss bank would lend 70 per cent of the approved valuation of the house, but competition for business led to loans of 80 and even 85 per cent. This was soon the basis of unhealthy speculation in building, which the National Bank sought to check. It brought all the banks into a "gentleman's agreement" whereby no bank should lend more than 70 percent of the valuation. This agreement is loyally observed by all classes of banks, which indeed are happier to see their traditional limits restored; it is said that the measure has had the desired effect in checking speculation in the building business.

Thus the National Bank, despite its extraordinarily restricted powers, has been able to wield considerable influence. It may be that the respect in which it is held has given it more real power to check unhealthy developments than would have been derived from wider statutory powers. Its task is perhaps simpler than that of the Bank of England, which has traditionally enjoyed powers as wide as those of the Swiss National Bank have been narrow. But Switzerland's financial prestige has brought with it the risks and the responsibilities of an international centre, and for such a centre there is much to be said for the Bank of England's prescription of power as well as influence.

This view has recently prevailed, and by a law promulgated at the end of 1953 the National Bank has become free to purchase bonds of the Federal Government, the Cantons, and the Cantonal Banks, subject only to the restriction that the bonds must be within two years of maturity. Such bonds may be included in the cover for the note-issue—subject still to the 40 per cent minimum in gold. It remains to be seen how this new power will be used. The Swiss money market is much narrower than those of London and New York, and it seems likely that the authorities will be cautious in using their new weapon. But it certainly is an important innovation, and should enable the Swiss authorities to act more decisively if there should be a renewal of inflationary forces.

TAXATION*

In general, an American resident in Switzerland may expect to be taxed on all income earned in Switzerland and on income arising from investments in Switzerland. The Swiss Federal Government, the cantons, and individual municipalities all levy certain income and property taxes within the scope of their authority.

Federal Income and Property Taxes

The national defense tax is a combined income and property tax levied on the net taxable income (including capital gains) and property of physical persons and legal entities.

The income tax on physical persons consists of a normal tax which begins at 0.4 percent of net income of 2,000 francs (unmarried persons) or 3,000 francs (married persons) and reaches a maximum of 9.75 percent of net incomes of 60,000 francs or more (unmarried persons) or 77,000 francs (married persons). In addition to the normal income tax, there is a surtax of 100 percent of that portion of the normal tax which is in excess of 1,000 francs.

The property tax ranges from 0.05 percent to 0.35 percent of the value of an individual's total estate, including real or personal property, both tangible and intangible, if located within Switzerland. Certain trust funds, foundations and associations are considered as physical persons under Swiss law.

The income tax on legal entities ranges from 3 percent to 12 percent and is graduated in accordance with the yield on capital invested. A surtax is levied on corporations whose annual net profits are over 5,000 francs and in excess of 8 percent of the capital invested. The surtax amounts to 20 percent of the net profits in excess of the 8-percent yield.

The property tax on businesses is a flat 0.07 percent of capital and reserves.

Cantonal Income and Property Taxes

No general statement can be made regarding cantonal and municipal tax rates, inasmuch as each canton has its own tax laws which vary in many details. The majority of cantons apply different tax rates to persons and legal entities.

Every canton has its fixed legal tax rates for physical persons, expressed in a percentage of the net income. Every year the cantonal legislature decides whether the taxes shall be levied at the legal tax rates or in a fraction or multiple thereof. The rate thus decided upon becomes the annual tax base, which may change every year. Unearned

*Excerpt from U. S. Department of Commerce, Bureau of Foreign Commerce, "Establishing a Business in Switzerland," World Trade Information Service, pt. 1, No. 55-101 (November 1955).

income is generally taxed at a much higher rate than earned income. Municipal or communal taxes are fixed as a percentage of the cantonal taxes.

An indication of the variations in Federal, cantonal, and municipal tax rates for individuals and corporations is given in tables 1 and 2, respectively.

Nine cantons treat legal entities like physical persons. In the other 16 cantons, businesses are subject to a special tax. Most of these cantons use the same system as the national defense tax, i. e., a tax on net profits at a rate determined by the yield on investment. The capital and reserves of a company are subject to a property tax which varies in the different cantons from 0.05 percent to 0.2 percent.

TABLE 1.—*Representative taxes paid by individuals in largest cities, 1954* [1]

[In Swiss francs]

City	Federal taxes (income and property tax)	Cantonal income and property tax	Communal income and property tax	Total
Zurich	178	246	347	771
Bern	178	383	396	957
Basel	178	279	0	457
Lausanne	178	287	238	703
Geneva	178	343	252	773

[1] Taxes to which a married taxpayer without children having a taxable annual income of 10,000 francs earned income of 8,000; unearned, 2,000) and holding property valued at 50,000 francs would be liable.

TABLE 2.—*Representative corporation taxes in largest cities, 1954* [1]

City	Annual net profits (Swiss francs)			
	0	50,000	100,000	200,000
	Cantonal and communal taxes			
Zurich	3,870	7,095	16,770	55,470
Bern	6,411	11,754	27,783	49,154
Basel	5,500	8,286	14,300	32,500
Lausanne	3,084	6,108	12,308	29,649
Geneva	2,820	5,238	11,823	32,655
	Federal taxes			
Zurich	750	1,977	5,313	13,522
Bern	750	1,842	4,218	14,642
Basel	750	1,944	5,550	17,625
Lausanne	750	2,007	5,664	18,112
Geneva	750	2,095	5,818	17,625

[1] Taxes to which a company having capital and reserves of 1,000,000 francs and immovables valued at 500,000 francs would be liable.

MISCELLANEOUS TAXES

A number of miscellaneous taxes are levied in Switzerland, both by the Federal Government and the cantonal authorities. The major Federal taxes are: Stamp tax, levied on bonds, securities, bills of lading and exchange, etc.; compensation tax, a turnover tax levied on department, chain, and retail stores with a turnover exceeding 200,000 francs; withholding tax, collected on various dividends and other payments by banks, and usually returned, to induce taxpayers to declare holdings; excise taxes on beer and tobacco; and sales tax. Customs duties also figure in Federal tax receipts as a major item.

Most cantons levy various miscellaneous taxes which include: Automobile tax, death tax, cantonal stamp tax, advertising tax, tax on change of real estate ownership, real estate profits tax, water tax, and other small locally collected taxes. These taxes are minor, however, compared with the cantonal income and property tax, which is the mainstay of cantonal revenue.

AN ACT OF THE FEDERATION FOR THE CONSTITUTIONAL REVISION OF THE BUDGET OF THE FEDERAL GOVERNMENT*

(Enacted January 31, 1958)

Be it enacted by the Legislative Assembly of the Swiss Confederation, pursuant to Article 85, Section 14, Article 118, and Article 121, par. 1 of the Federal Constitution, after consideration of a Message from the Federal Council, of February 1, 1957 [1]

I

The Federal Constitution shall be amended as follows:

Article 18, par. 4

The tax on exemption from military service shall be collected by the cantons for account of the Federal Government in accordance with federal legislation.

Article 41a

1. The Federal Government shall have power to levy the following taxes:

a. Stamp duties on securities, including coupons, bills of exchange and similar commercial paper, insurance premium receipts and other instruments of trade and commerce. This taxing power shall not extend to deeds and conveyances of realty or realty mortgages. One-fifth of the net proceeds of the stamp duties shall accrue to the cantons.

b. An offsetting tax [*Verrechnungssteuer, impôt anticipé*] on capital yields other than real estate, on lottery winning and on insurance benefits;

c. Excises on raw and manufactured tobacco;

d. Special taxes payable by residents abroad to avoid the imposition of taxes by foreign countries.

2. Items which by legislation are subject to federal taxation in accordance with par. 1 (a) to (c), above, or is declared tax exempt, shall not be liable to cantonal or municipal taxes of the same kind.

3. This Article shall be implemented by federal legislation.

Article 41b

1. In addition to the taxes accruing to it under Article 41a, the Federal Government shall have power to levy during the years 1959 to 1964 a general sales tax, a defense tax and a tax on beer.

2. The following shall apply to the general sales tax:

a. A tax shall be levied on domestic sales of goods, on merchandise imports and on paid labor expended upon chattels, construction work and realty except cultivation of land for crop production. Sales transactions taxed or declared tax-exempt by the Federal Government shall not be subject to the same type of tax by cantons or municipalities;

b. The tax shall not exceed 3.6 per cent of the amount of retail sales, nor 5.4 per cent of the amount of wholesale transactions;

c. No deletions from or additions to the list of goods exempt from taxation on sales, constituted as of January 1, 1959, shall be made.

3. The following shall apply to the national defense tax:

a. A tax shall be levied on individual incomes, and on corporate net profits, capital stock and reserves;

b. The tax on individual incomes shall be levied according to a progressively graduated scale, and shall not exceed 8 per cent of the total taxable income. Taxable income is net income of 6,000 francs or more, in the case of married persons 7,500 francs or more;

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*Translation by U.S. Department of State.

[1] Federal Gazette (Bundesblatt) (1957), pt. I, p. 505.

c. Corporate entities, regardless of their legal form, shall be taxed as uniformly as possible in accordance with their earning capacities. The tax on net profit shall not exceed 5 per cent when assessed proportionally, or 8 per cent when assessed on a progressively graduated scale; the tax on capital stock and on reserves shall not exceed .75 per mil;

d. This tax shall be collected by the cantons for account of the Federal Government. Three-tenths of the gross tax yield shall accrue to the cantons; of this amount, one-sixth shall be utilized for fiscal equalization between the cantons.

4. The total incidence on beer, in the form of the tax on beer, supplementary customs duties on brewery raw materials and on beer, and the sales tax, shall neither be increased or decreased in its ratio to the price of beer as of December 31, 1958.

5. This Article shall be implemented by federal legislation.

Article 42

To meet the expenses of the Federal Government, the following revenues are available:

a. Income from property of the Federal Government;

b. Net income of the Postal, Telegraph and Telephone Administration (Art. 36) and of the Gunpowder Administration (Art. 41);

c. Net yield of the military exemption tax (Art. 18, par. 4);

d. Income from customs duties (Art. 30);

e. Federal share of the net yield from taxes on distilled beverages (Art. 32a, Art. 34c, par. 7), and of the gross receipts from gambling establishments (Art. 35, par. 5);

f. Federal share of the net profits of the exclusive bank of issue (Art. 30, par. 4);

g. Yield from federal taxes (Art. 41a *et seq.*);

h. Receipts from fees and other statutory revenues.

Article 42a

The cumulative deficit in the financial statement of the Federal Government shall be consistently reduced. This shall be effected with due regard to the economic situation.

Article 42b

The Federal Government shall promote fiscal equalization among the cantons. In particular when making federal grants-in-aid, proper consideration shall be given to the fiscal capacities of the cantons, and to the mountain regions.

Article 42c

The Federal Government shall have authority to enact legislation against unwarranted tax relief allowed to taxpayers on the basis of agreements.

II

The Transitional Provisions of the Federal Constitution shall be amended as follows:

Article 6

The cantonal share of the yield from the military exemption tax, including the collection commission [*Bezugsprovision*], for the years 1959 and 1960 shall be fixed at 31 per cent of the gross yield. Beginning January 1, 1961, this share shall be replaced by a collection commission of 20 per cent. Any provisions of Federal legislation in conflict herewith shall be repealed.

Article 7

1. Beginning January 1, 1959, no stamp duties on freight documents shall be levied. Any provisions of federal legislation in conflict herewith shall be repealed.

2. No cantonal stamp duties or registration fees shall be levied on freight documents covering transportation of baggage, animals or freight by the Swiss Federal Railways or by federally licensed carriers.

Article 8

1. Until such time as new legislation implementing Article 41(a), par. 1, (a) and (b), and Article 41b shall go into effect, the present provisions governing taxes levied pursuant to the Revenue Regime for 1955–58, except the Federal Act of December 21, 1955 reducing the defense and general sales taxes, shall remain in force, for the following:

a. The stamp duties, with the rate of duty on coupons reduced from five per cent to three per cent effective January 1, 1959;

b. The offsetting tax, with the rate of tax increased from 25 per cent to 27 per cent effective January 1, 1959. Concurrently the tax-free amount of interest earned on savings and time deposits registered in depositors' names shall be increased from 15 francs to 40 francs;

c. The withholding tax [*Abzugssteuer*] on life-insurance benefits;

d. The general sales tax;

e. The national defense tax;

f. The tax on beer.

2. The Order of the Federal Council concerning the general sales tax shall be amended effective January 1, 1959, as follows:

a. The general sales tax shall be 3.6 per cent of the amount of the retail transactions, and 5.4 per cent of the amount of wholesale transactions;

b. The list of goods exempted from the sales tax as of December 31, 1958 shall be extended to include all goods which on that date were subject to a tax of 2 and 2½ per cent, also medicines and books.

3. The Order of the Federal Council concerning the levy of a national defense tax shall be amended with respect to the tax years commencing after December 31, 1958, as follows:

a. The supplementary tax on individual incomes shall be repealed;

b. The following shall apply to the tax on individual incomes:

(1) The deduction for married persons shall be 1,500 francs;

(2) The annual tax shall be:

On incomes up to 5,999 francs: 0.

On incomes of 6,000 francs: 10 francs, and for each 100 francs of income in excess thereof, 1 franc additional.

On incomes of 15,000 francs: 100 francs, and for each 100 francs of income in excess thereof, 3 francs additional.

On incomes of 25,000 francs: 400 francs, and for each 100 francs of income in excess thereof, 6 francs additional.

On incomes of 40,000 francs: 1,300 francs, and for each 100 francs of income in excess thereof, 8 francs additional.

On incomes of 60,000 francs: 2,900 francs, and for each 100 francs of income in excess thereof, 10 francs additional.

On incomes of 85,000 francs: 5,400 francs, and for each 100 francs of income in excess thereof, 12 francs additional.

On incomes of 120,000 francs: 9,600 francs, and for each 100 francs of income in excess thereof, 8 francs additional.

c. The following shall apply to the tax on corporate incomes:

1. Stock corporations and cooperatives shall pay a basic tax of 3 per cent on net profit; and—

a surtax of 3 per cent on that portion of net profits in excess of a 4-per cent return on capital; or, in the event that capital stock and reserves amount to less than 50,000 francs, on that portion of net profits in excess of 2,000 francs;

a further surtax of 4 per cent on that portion of net profit in excess of an 8-per cent return on capital; or, in the event that capital stock and reserves amount to less than 50,000 francs, on that portion of net profits in excess of 4,000 francs.

In no case shall the tax exceed 8 percent of net profits.

2. All other forms of corporate entities shall pay income tax in accordance with the provisions applicable to individual incomes;

3. The tax on the capital stock and reserves of stock corporations and cooperatives, and on the property of other forms of corporate entities, shall be proportional and shall be .75 per mil;

d. The national defense tax on refunds and discounts in connection with purchases of goods shall be 3 per cent on that portion of refunds and discounts which exceeds 5.5 per cent of the price of the goods.

4. The Federal Council shall harmonize its Orders concerning the general sales tax and the national defense tax with the changes in paragraphs 2 and 3, above.

5. Until such time as federal legislation shall revise the program of main highway construction, the provisions of the Revenue Regime of 1955–58 governing highway grants to cantons shall continue in force even after December 31, 1958. The share due cantons from the net yield of motor-fuel taxes shall in the interim be increased to 60 per cent, one-sixth of which shall be set aside for additional promotion of main highway construction. Details shall be regulated by an act of the Federal Legislature, which shall be universally binding.

6. Until such time as federal legislation shall revise the financial relationship between the Federal Government and the Swiss Accident Insurance Institution, the proivsions of the Revenue Regime of 1955–58 respecting federal grants to this Institution shall continue in force even after December 31, 1958.

III

1. The provisions of the Federal Constitution enumerated in Section I and Section II shall take effect on January 1, 1959.

2. The regulations governing stamp duties on freight documents, and the Regulations in force under the Revenue Regime of 1955–58 which have not been extended, shall continue to be applicable even after December 31, 1958 with respect to questions of fact or law which may have arisen or developed prior to that date.

IV

1. This Act of the Federal Legislature shall be submitted to the vote of the people and of the States.

2. Execution thereof shall be the reponsibility of the Federal Council.

So approved by the National Council, Bern, January 31, 1958:

R. BRATSCH, *President.*
CH. OSER, *Recorder.*

So approved by the Council of States, Bern, January 31, 1958:

FRITZ STÄHLI, *President.*
F. WEBER, *Recorder.*

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UNITED KINGDOM

CENTRAL BANKING IN THE UNITED KINGDOM*

Historical Setting

The Bank of England was chartered by act of Parliament in 1694. In 1844 it was given sole right of note issue. By the second half of the 19th Century, the public service aspects of the Bank's activities began to eclipse its private banking business. It became the lender of last resort to the money market and the regulator of the great international gold and capital market in London.

Ownership, Control, and Relationship to the Treasury

By 1926, relations between the privately-owned Bank of England and the Government were so close that the then Governor, Montagu Norman, noted that the Bank had the right to offer advice but was always subject to the "supreme authority of the Government."

In 1946, the Bank was nationalized by act of Parliament. The Government acquired the entire capital stock of the Bank, and was empowered to appoint the Governor, Deputy Governor, and Directors of the Bank for fixed terms. The Treasury was empowered to give directions to the Bank, after consultation with the Governor, and the Bank was empowered, upon authorization from the Treasury, to request information from and give directions to the commercial banks when it thought this necessary in the public interest.

Nationalization of the Bank was generally regarded as primarily codifying by statute an existing relationship between the Bank and the Treasury. Since nationalization, the Bank has continued to operate and to advise the Government in much the same way as before.

Instruments of Monetary Policy

By long standing practice a change in Bank Rate is followed immediately by corresponding adjustments in commercial bank deposit and lending rates. However, the Bank of England discounts directly only for the twelve London discount houses who make a market for short-term Government and commercial obligations, and are financed by secured loans from the highly concentrated clearing banks. If the clearing banks reduce their call loans to the discount houses, the latter in turn attempt to become liquid again by selling some of their assets to nonbank money market institutions, and failing this, resort to discounting at the Bank of England at what is usually a penalty rate.

The Bank of England can influence money market rates in a desired direction by open market operations or by refusing either to relieve

*Prepared at the request of the Joint Economic Committee by the Division of International Finance, Board of Governors of the Federal Reserve System, Washington, D. C.

shortages or to absorb surpluses of funds resulting from seasonal and cyclical developments. In a period of monetary restraint the banks can thereby be deprived of reserves and the market ultimately forced into the Bank of England at penalty rate. In times when the Bank wishes to encourage easier money market conditions it may offer to purchase assets directly from the market at current rates. The Bank of England's transactions in the short-term securities market are carried out by its "bill broker"—one of the London discount houses. Longer-term securities (over 5 years) are handled by the "government broker"—one of the large private brokers in the government bond market.

As a matter of traditional practice the commercial banks are committed to maintain a minimum ratio of cash reserves to deposits of eight per cent and strive to maintain customary minimum ratios of liquid assets to deposits. In the postwar period, the very large public debt, much of it in the form of bank held Treasury bills, has made it difficult to keep the volume of bank reserves under control. With liquid asset ratios normally well in excess of the minimum, the banks would find it relatively easy to convert these assets to cash when their cash reserves were under pressure, and would thus be under little compulsion to reduce their deposits. This has led to periodic "requests" to the banks by the Bank of England to restrain their lending activities.

In addition the Bank has engaged in continuous funding of short-term debt when it was able to establish conditions favorable to the sales of longer-term securities. For this purpose the Bank of England has at its disposal not only its own securities holdings but also the large portfolio of the various "departments" of the Government.

The Chancellor of the Exchequer appointed a Royal Commission called the "Radcliffe Committee" in April 1957 "to inquire into the working of the monetary and credit system and to make recommendations." The report of this committee expected in 1959 should throw considerable light on the formulation of monetary policies in Britain.

Channels or Sources Supplying Business Capital

The Bank of England owns 30 per cent of the share capital of the Finance Corporation for Industry Ltd., which was formed in 1946 "for the re-equipment and development of major industries with a view to promoting efficiency." The Bank also has a token participation in the Industrial and Commercial Finance Corporation Ltd., also set up in 1945, which has as its main object "the provision of credit and finance by means of loan capital and share capital for industrial and commercial concerns in Great Britain, particularly in cases where the existing facilities provided by banking institutions and the Stock Exchange are not readily or easily available."

STRUCTURE OF THE BRITISH CREDIT SYSTEM*

The eleven banks which are members of the London Clearing House are together responsible for some nine-tenths of the total resources of all the commercial banks (including those in Scotland and Northern Ireland). The commercial banks receive sight deposits on current account and deposits at seven days' notice. At present, of the outstanding credit granted by the commercial banks only one-third is in respect of the private sector (here taken to include the nationalised industries, which together accounted in November 1956 for less than 5 per cent. of total advances), the remaining part consisting of securities, etc., mostly government paper. Of the banks' lending to private business the discounting of trade bills now represents only a small fraction, the bulk of it consisting of advances and overdrafts formally repayable on demand but subject to review every six months and renewable. Acceptances, although they do not amount to as much as direct lending, nevertheless constitute a very important service to the banks' customers.

British commercial banks do not receive savings deposits (with the exception of amounts received from Home Safe accounts, on which 3½ per cent. interest is paid) and do not, on principle, lend at long term.

Small savings are for the most part collected by the Trustee Savings Banks and the Post Office Savings Banks or directly by the Treasury through the issue of defence bonds, tax-free savings certificates and, since November 1956, Premium Savings Bonds, on which no interest is payable but which will participate in monthly drawings for prizes from June 1957. As the Trustee Savings Banks pass on to the National Debt Commissioners the savings deposits which they receive in their ordinary departments, most of the funds entering these five channels for monetary savings flow to the Treasury. The remaining funds are those which are received by the Special Investment Departments of the Trustee Savings Banks, which accept notice deposits and use them to buy approved securities. The said five channels account for the whole of the total of over £6 milliard of "national savings" outstanding. This amount is nearly as large as the total of the sight and notice deposits held by the clearing banks.

There are also other institutions collecting savings quite apart from the various forms of insurance saving, the most important group being that composed of the nearly 800 building societies, which hold some £1.9 milliard of savings, these being invested for the most part in long-term mortgages connected with the purchase of houses by their members.

*Bank for International Settlements, Monetary and Economic Department, "Credit and Its Cost" (CB 268), Basle, Switzerland, January 1957.

A few specialised institutions, mostly of recent creation, are concerned with medium and long-term financing:

(i) The Agricultural Mortgage Corporation, established in 1928, and The Scottish Agricultural Securities Corporation, established in 1933, raise funds by the issue of bonds and grant first-mortgage loans repayable in up to 60 years to borrowers intending to buy or improve a farm.

(ii) Industrial and Commercial Finance Corporation (I. C. F. C.) has an authorised capital of £15 million (50 per cent. paid) subscribed in small part by the Bank of England but predominantly by the clearing and Scottish banks. It has powers to borrow in addition up to £30 million from its shareholders. It grants relatively small loans (from £5,000 up to £200,000) or subscribes for shares. These loans are complementary to the commercial banks' advances but are given for periods of up to 20 years.

(iii) The Finance Corporation for Industry (F. C. I.) has an authorised capital of £25 million (2 per cent. paid) held about equally by the Bank of England, the investment trusts and the insurance companies, and has powers to borrow from the clearing and Scottish banks up to £100 million. Lending is mostly at medium term but for amounts of at least £200,000, the loans being provided for the purpose of the reorganisation or re-equipment of major industries (iron and steel, etc.).

(iv) The National Film Finance Corporation gives support to the film industry, using funds supplied chiefly by the Board of Trade. Loans are granted for up to five years and privilege rates are charged.

(v) The Estate Duties Investment Trust (Edith), established in 1953, is intended to provide funds to meet estate duties in cases where assets consist of shares in private companies. The Trust is managed by the I. C. F. C.

(vi) Ship Mortgage Finance Company Limited was set up to make medium-term loans on first mortgages of ships, raising money for this purpose by the issue of medium-term debentures or other securities. The company's authorised capital is £1 million (50 per cent. paid) subscribed by the Shipbuilding Conference, insurance companies and other finance institutions.

(vii) Air Finance Limited was set up to assist aircraft manufacturers to develop exports by offering longer credit facilities to overseas customers. The capital of the company has been provided by the F. C. I., the merchant banks and, to a lesser extent, the aircraft industry. In addition to the issued capital, the company has special loan arrangements with the F. C. I., as well as normal banking facilities.

(viii) The Commonwealth Development Finance Company Limited, established, like the last-mentioned company, in 1953, assists projects for the expansion of the sterling area's resources and the strengthening of its balance-of-payments position. The Bank of England has subscribed part of the capital.

(ix) Two other institutions operating in the medium and long-term sectors are: Private Enterprise Investment and The Safeguard Industrial Investment Limited.

All these institutions together have at present about £130 million of credit outstanding.

There are in London, besides the commercial banks, whose primary function is the financing of the economy in general, other groups of institutions whose activities are more specialised but whose aggregate importance is very great. There are the merchant bankers and the acceptance houses, whose primary concern is with the financing of foreign trade, but which in fact overlap, so far as function is concerned, with the issue houses, which, as the name implies, are concerned with the placing of new capital issues. Mention must also be made of the head offices of banks whose main field of activity is overseas, and of the London offices of dominion, colonial and foreign banks, which are primarily concerned with banking activities abroad but are also, in so far as they do individual banking business in London, direct competitors for deposits and for loans with the London Clearing Banks. The growth of "instalment buying" has added greatly to the importance of the houses dealing with "installment finance", both as lenders and as borrowers, for the rates of interest which they are currently offering for deposits are greatly in excess of those offered by the commercial banks, the savings banks or the building societies.

More important, however—if not in the credit field proper, at least for the working of the London money market—are the twelve discount houses, whose combined assets amount to over £1 milliard. They borrow, mostly at very short term, from the commercial banks and other institutions and invest chiefly in Treasury bills.

Under the Bank of England Act, 1946, the Bank of England has power "to request information from and to make recommendations to bankers, and may, if so authorised by the Treasury, issue directions to any banker for the purpose of securing that effect is given to any such request or recommendation: Provided that: (a) no such request or recommendations shall be made with respect to the affairs of any particular customer of a banker; and (b) before authorising the issue of any such directions the Treasury shall give to the banker concerned, or such person as appears to them to represent him, an opportunity of making representations with respect thereto." The Bank has not used this power to issue directions. It does not impose on the banks minimum reserve requirements (though since the war there has been a conventional minimum of 8 per cent. for the cash ratio), limits on advances, etc. The Bank can influence the monetary situation by means of changes in the Bank rate and by operating in the open market. The government from time to time indicates to the Capital Issues Committee (see below), by means of a "memorandum of guidance", principles which it wishes to see followed in investment policy. When these principles also affect bank lending the Chancellor, through the Governor of the Bank of England, requests the banks to observe such principles. The Governor's action is to bring the principles in question to the notice of the domestic, overseas and foreign banks, the acceptance houses, and the Finance Houses Association. The principles are stated in general terms; their detailed application is left to the decision of the financial institutions concerned, but the Bank of England is ready to advise on any difficulty of interpretation that may arise. In some instances the Chancellor may make requests to the banks independently of any instructions given to the Capital Issues Committee.

The *Capital Issues Committee* (C. I. C.) advises, under the Borrowing (Control and Guarantees) Act of 1946, the Treasury on all new borrowing over (at present) £10,000 in any one year. Bank advances also require the consent of the C. I. C. when they exceed £10,000, unless they can be considered as borrowing "in the ordinary course of business."

By the end of the summer of 1956 practically the whole of the interest-rate structure had adapted itself to the 5½ percent. Bank rate fixed in February of that year. Bank rate is the minimum rate at which the Bank of England will discount approved Bills of Exchange. Currently the Bank of England also makes advances at that rate for a minimum period of 7 days against eligible security. Such facilities are available only to the discount houses. Bank rate determines the basic level of all other rates, which traditionally are kept at more or less fixed differentials above or below Bank rate. For example, the majority of commercial banks' advances are usually made at ½ to 1 per cent. above Bank rate and their rate for 7-day deposits is normally 2 percent. below Bank rate.

On the money market day-to-day and very short-term loans are made by the clearing banks at a rate of 3¾ (good money) to 4¾ per cent. and three-month Treasury bills are issued at a discount of about 5 per cent.

On the capital market the average yield of government bonds is about 5¼ per cent. and that of industrial bonds 5¾ to 6¼ per cent. In Great Britain the issuing costs for fixed-interest-bearing securities of well-known corporations are not as high as in many other countries; but, even so, the real cost of money raised in this way cannot be estimated at less than 6 to 6½ percent.

The commercial banks discount fine trade bills (3 to 6 months) at around 6 to 6½ per cent. and on most advances and overdrafts they charge from 6 to 7 per cent. (i. e. ½ to 1½ per cent. over Bank rate). In periods of credit squeeze, such as the present, customers who would have been charged higher rates are not granted credit at all.

Mortgage loans are granted by the Agricultural Mortgage Corporation at 5¾ per cent., and the building societies lend their funds on house mortgages at 5½ to 6½ per cent. The Public Works Loan Board has raised the cost of its lending to local authorities and other public bodies to 5¾ per cent. for loans of over 5 years' duration.

While no *formal* agreement exists between the British banks with regard to charges on advances, formal interbank agreements do exist with regard to short-term and call-money rates and the rates of interest to be paid on deposits.

No interest is paid on sight deposits, but on seven-day-notice deposits the interest allowed is now 3½ per cent. The Post Office and Trustee Savings Banks pay 2½ per cent. to depositors on ordinary savings accounts (the first £15 of interest being free of income tax) and the Trustee Savings Banks pay 3 to 4 per cent. on notice deposits in their special investment departments. In May 1956 defence bonds were issued at 4½ per cent., and the principal building societies have increased the rates paid to their shareholders to 3½ per cent., tax free, which corresponds—at the normal income-tax rate—to over 6 per cent. gross income for the saver. There are also financial institutions which deal with hire-purchase financing, and which, earning the usual high rates obtained everywhere in this field, compete with the other institutions for deposits by offering rates of 6 to 8 per cent.

Great Britain: Main rates paid and charged by credit institutions (including commission, etc.)

[In percentages]

Items	Bank of England	Commercial banks	Other credit institutions
Rates paid on—			
Sight deposits			
Time and savings deposits		3½	[1] 2½–4½
Call money		3¼–4¾	
Rates charged on—			
Trade bills (discounting)	5½	6–6½	
Advances and overdrafts		6–7	
Mortgage loans			5½–6½

[1] Defense bonds. Tax-free savings certificates and especially savings shares in building societies give a gross rate which is normally much higher.

RELATIONS BETWEEN THE BANK OF ENGLAND AND THE COMMERCIAL BANKS OF THE UNITED KINGDOM *

Sir Cecil Ellerton

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*A lecture before the Tenth International Banking Summer School, Garmisch-Partenkirchen, Germany, Sept. 20, 1957. In consenting to the reprinting in these materials, Sir Cecil wishes it noted that events since the lecture was given might call for some revision of the data and conclusions.

In his paper to the first International Banking Summer School at Oxford in 1948 Professor R. S. Sayers spoke about the functions of central banks, referring in particular to the Bank of England and the Federal Reserve System, and in so doing discussed the various developments which had taken place in central banking technique during the two previous decades. In 1931 the authoritative Macmillan Committee had concluded that the chief function of a central bank was to keep the economy on an even keel, and that it should use for this purpose the power to vary the volume of credit afforded by open market operations and Bank rate. In retrospect modern bankers may think the Committee over-simplified the work of a central bank, yet we may be sure that this relatively uncomplicated conception found general acceptance among bankers at that time.

The famous Bank Charter Act of 1844, by providing an automatic mechanism for controlling the note issue, had discouraged any notion of central bank credit control, and not until Walter Bagehot had written "Lombard Street", did the Directors of the Bank begin to reconsider their responsibility in these matters. Eventually this doctrine became fully accepted; as one of the Bank's great Governors, Montagu Norman, put it "It would further be the duty of a central bank to effect, so far as it could, suitable contraction and suitable expansion, in addition to aiming generally at stability, and to maintain that stability within as well as without". But, and possibly in order to settle finally some difference of opinion which had occurred during the first world war, Montagu Norman made the following qualification "I look upon the Bank as having the unique right to offer advice and to press such advice even to the point of 'nagging' but always of course *subject to the supreme authority of Government*". It is not without point to recall that not so long ago a Labour Chancellor of the Exchequer stated that the Bank of England was "his creature", but, realising perhaps that even he had gone a little too far, added "like so many creatures it sometimes goes its own way". This tenacity of purpose, we may hope, it will continue to possess.

During the 1920's, when Montagu Norman expressly acknowledged the supreme authority of the Government, central banks in many parts of the world managed to build up an imposing facade of independence, and at the same time imbued their techniques with a somewhat mystical air. The notion of complete central bank independence, however, failed to survive the depression and in the 1930's Governments gradually assumed responsibility for internal financial matters. Changing relationships between Government and central bank could not however be without their effect. As Government activities began to make a greater impact on the economy so relationships became more positive between the central bank as representing the Government and the commercial banks as representing the private sector.

The methods by which it was originally thought a central bank should be able to control the volume and terms of credit were, as I have noted, principally: —

i. Open market operations or the buying and selling of assets in the market by the central bank. These transactions affect the liquidity of the banks by expanding or contracting their cash. By cash is meant not merely till (or vault) money, but balances with the Bank of England;

ii. the use of Bank rate.

Open market operations affect in some way the business of all members of the financial community but more specifically the clearing banks which provide nearly all the bank credit available and upon whom accordingly pressure becomes exerted most effectively.

There have been important changes in the open market technique of the Bank of England during the years. Such operations were at one time confined to the short-term market in Government paper, but the introduction of cheap money in 1932 forced the Bank to become interested at least for a time in a far wider list of securities. Since the second world war, however, dealings in Government stock have often been a matter of some delicacy and at times the authorities have found it well nigh impossible to sell securities in any effective quantity;

in general the Bank continues to rely for the most part on short bonds and bills for open market operations. It is interesting to observe too a new development in the way the general public has been attracted to Treasury bills, a movement which has been stimulated by the gap which opened up between the Treasury bill rate and the rate on bank deposits as money market rates became more flexible; in consequence many public companies have been encouraged to put their liquid assets into Treasury bills. This movement has been welcomed by the authorities because it has the same effect as an open market operation and reduces the liquid resources of the clearing banks. Open market operations also receive support from what might be called "the spheres of interest" of the Bank of England. These are such Government agencies as the national insurance and pension funds, the Exchange Equalisation Account and overseas currency boards, all of which have at times substantial funds to deploy.

Whenever the authorities find it impossible to sell securities in effective quantity the consequences may be serious. It means that the Government may have to rely too much on the issue of short-term Treasury bills financed by the banks to cover not merely the temporary current requirements of the Government, but, and more seriously, their capital requirements and those of the nationalised industries such as the mines, gas and electricity undertakings. From the monetary point of view this is unsound because it may lead so easily to demands on economic resources unmatched by current savings, a point which has been at least taken not only by the central bank but by successive Governments, and not only in my own country but in other parts of the world. Treasury bills are "near cash" and when held by banks will have the effect of increasing their liquid resources and their liquidity ratios; such issues of Treasury bills have been referred to as the modern version of the printing press. To neutralise their potential effect in some way the central bank has to seek an opportunity to turn these Treasury bills into medium or long term issues; to fund them in other words, and thereby to reduce the liquid resources of the clearing banks. These funding issues have not in recent years been very well received by the market and, in consequence, the authorities have had initially to take up much of such issues themselves.

Central banks everywhere attempt to restrain or to encourage the activities of commercial banks by bringing about changes in commercial bank liquidity, but re-discount facilities are permitted in order to avoid unnecessary difficulties over the availability of cash. In many countries these re-discount facilities are based on direct arrangements between commercial and central banks, but in Britain the discount market is interposed between these two organisms, a British practice which dates from the 19th century when a large-scale call money system was developed by London joint-stock banks anxious to get an immediate return on money deposited with them. At all events, the British custom is for the banks to call in loans from the discount market and to force it in turn to borrow from the Bank of England.

The discount market consists of twelve individual houses which provide a suitable outlet for the employment of funds at the disposal of the clearing banks and to provide the Government with day-to-day finance by means of Treasury bills. It also provides a market for carrying some part of the Government short-term bonds which, for one reason or another, it has not been able to issue as medium or long-term loans. At the present time the main work of the discount market is concerned with the finance of Treasury bills which are perhaps the most important influence on the market. By reason of its extensive activities the Government, through its various departments, finds itself week by week in the position of being a substantial payer or receiver of funds, according to the period of the year. The Treasury and the Bank of England estimate on a weekly basis the amount of the net receipt or net disbursement which may be expected to result from transactions under all headings. They then proceed to offer for tender, again on a weekly basis. Treasury bills to an amount which, taking into account the Treasury bills maturing, should balance their accounts. By a custom established for some years now the clearing banks do not tender directly for these Treasury bills; this is done by the discount market members who bid for the bills with the resources at their disposal, either their own capital or deposits which they can secure, or, more particularly, loans which they obtain from the banks, especially the clearing banks.

With this rough sketch of the part played by the discount market in mind we may turn once again to the liquidity of the clearing banks. By convention (and I emphasise that it is by convention) the commercial banks contrive to keep a minimum of 30 per cent. of their deposits (current accounts and time deposits) in liquid form. This 30 per cent., when at the minimum, would consist of 8 per cent. cash (cash in hand and balances with the Bank of England) and 22 per cent.

in bills discounted (both Treasury and commercial bills; the commercial bills today are not very much more than 10 per cent. of the total) and loans at call to the money market. When the liquidity ratio of the clearing banks is above 30 per cent. the increase will be found in these bills or call money; the 8 per cent. cash remains constant and on only rare occasions would it fall below that figure, any deficiency being quickly made good by an individual bank calling in its loans from the money market or allowing Treasury bills to run off. Treasury bills or call money mean very much the same thing so far as bank liquidity is concerned. The money market use their call money to take up Treasury bills which may then subsequently be sold to the clearing banks or other purchasers, or deposited against loans. Bank liquid assets therefore consist very largely, directly or indirectly, of Government short-term obligations.

The question has been raised from time to time whether it would not be more logical to establish contact between the Bank of England and the clearing banks for the purpose of Treasury bill finance. My own view is that on balance little would be gained by such a change. The Government could possibly finance their borrowings in Treasury bills a little more cheaply if they dealt directly with the banks but the banking system would lose much of its present flexibility. The money market mechanism enables funds to flow smoothly round the banking system and the central bank would be forced to take over this work if sudden and unnecessary dislocations in our monetary arrangements were to be avoided.

Criticism of the present system of Treasury bill finance has led some people to desire the reintroduction of some form of compulsory deposit by the commercial banks with the central bank on the lines of the Treasury Deposit Receipts which came into use during the war. These Treasury Deposit Receipts were introduced to take out of the banking system money necessarily created by Government expenditure, and each commercial bank had to take up a volume of Treasury Deposit Receipts in accordance with its deposits. These T.D.R.s, as they were called, were not cashable except in an emergency, but they could be used to take up a Government long-term issue, the latter transaction being a form of funding. As an alternative to the Treasury bill the Treasury Deposit Receipt would scarcely be welcomed by bankers or others as it would be far less of a liquid assets. If T.D.R.s were to be reintroduced to supplement borrowing on Treasury bills, and the banks were not allowed to count them among their liquid assets, we should probably witness in effect the worst defect of a system of variable liquidity ratios, that is a high mandatory ratio necessitated by excessive short-term borrowing by the Government through the banks.

There has recently been in Britain a good deal of discussion on the suggestion of introducing a system of variable liquidity ratios in order to control bank credit. Such an instrument of control no doubt could be made to work but it would be difficult and clumsy in operation, and before adopting such a course we should be certain there is no practical alternative.

Putting on one side seasonal increases in Treasury bill borrowing, which I think we must consider legitimate, if a mandatory liquidity ratio were raised in order to neutralise the effect of an increase in Treasury bill borrowing through the banks caused by a high level of official expenditure, it is important that we should recognise this for what it is, a confession of failure on the part of the Government to live within either its income or those funds it can attract from the savings of the public. If, on the other hand, the liquidity ratio were raised in order to bring about a reduction in bank resources generally, then it seems that the banking system would be left with two alternatives, either a reduction in investments or a curtailment of advances. If the banks attempted to sell investments they would find themselves in the same predicament as the authorities in their own market operations, namely, an inability to sell securities except at the expense of a considerable fall in the price of Government securities and a consequent rise in the rate of interest. But, be that as it may, most of the comment on the desirability of mandatory liquidity ratios seems to be concerned with the system as a means of reducing bank advances; therefore, it would seem that the banks would not be allowed a freedom of choice either to sell their investments or to reduce their advances, but would be forced to reduce their advances by what would in one way or another be an arbitrary percentage. I believe that such a method would be harsh in its effect and incidence, and I can see little advantage in adopting such a system in place of the present method of directives which has allowed some measure of elasticity.

The traditional method of credit control is Bank rate which in 1951 was brought back into use after an absence of nearly 20 years. It had been reduced to 2 per cent. in 1932, and remained unchanged until the end of 1951, with an exception of a short period of a higher rate in the early months of the last war. Bank rate is the only rate which the Bank of England fixes specifically; it does not attempt to fix the deposit rate or the overdraft rate of the commercial banks. Deposit rate is usually fixed by the commercial banks at 2 per cent. under Bank rate but there have been periods when the two rates have been closer.

Overdraft rates are a matter for individual banks themselves to arrange with their customers, and they vary according to the standing of the customer and the nature of the advance. A fair average would be 3/4 per cent. over Bank rate with a tendency in recent years for the margin to fall. The banks do from time to time allow privileged rates for special lines of business, for example they would lend at lower rates to public bodies which, in all probability, have a direct or indirect guarantee of the Government, and also for export transactions where the underlying transaction was guaranteed by the Export Credits Guarantee Department. By and large, however, overdraft and loan rates are fixed by ordinary negotiation between banker and customer.

The use of Bank rate as an instrument of credit control is a matter of keen debate. There are those who claim that Bank rate, if used effectively, that is to say, if pressed to very high levels, must succeed in bringing about a contraction of credit. Supporters of this view admit that it would be exceedingly painful but that it can act effectively and quickly. The opponents of this classical conception of Bank rate maintain that it is too blunt an instrument, that it places too great a burden on our balance of payments, that it is out of touch with modern realities, and that more direct control should be introduced in its place. My own view is that Bank rate by itself can never achieve what was formerly expected of it because it operates in quite a different economy, at least so far as the United Kingdom is concerned. In gold standard days Bank rate was raised in order to attract funds to London, to make London an expensive centre for foreign boorowers, and to encourage investors to keep their money at home. Moreover, dear money was expected to have a restricting influence on domestic trade. Today it does not work in that way, with the possible exception of discouraging a certain amount of overseas borrowing in London. A high Bank rate is extremely limited in its effect in attracting foreign balances to London, and, in present conditions of full employment and high rates of taxation, in restricting the domestic economy.

The initial success that Bank rate appeared to have in 1952 and 1953 was due not so much to Bank rate as to the inevitable fall in raw material prices after the Korean boom, and to the fact that there was some overstocking in 1951. A high level of interest rates should normally tend to pull down the prices of Stock Exchange securities and thereby check new capital issues, discourage people from spending and, generally, place a restraint on expansion, but today it does not work like this. With full employment accepted by nearly everybody as a settled policy and with good internal markets supported by inflation and a high level of wages, there is a tendency for the price of equity shares to be less affected by changes in interest rates because investors look to future growth rather than to the present income.

It would, of course, be foolish to deny the effect that Bank rate has had, and it is important that Bank rate should pull in the same direction as other measures. In full employment, too, capital can never be cheap. But in my view a high Bank rate has not by itself materially reduced investment at home, nor has it greatly discouraged borrowers; consumption has been restrained only moderately and shows every sign of expanding again. The high rate of taxation, too, lessens the burden on borrowers because the interest paid on loans may be charged as an expense against income tax liabilities. Moreover, a good deal of investment is on Government and semi-Government account and is for that reason isolated to some extent from the effects of interest rate changes.

The restraint on the distribution of profits and reasonable depreciation allowances have enabled some industries to set aside substantial reserves from which they have been able to finance their own investment programmes without resort to the capital market. This self-financing is probably inevitable in an inflationary economy, and although companies may have become considerably less liquid during the past year self-financing is likely to continue to be a more important source of capital finance than in the past. The slowing down in the tempo of economic affairs which occurred in 1956 was due very largely to the other measures taken by the Government, for example, the reduction of certain subsidies, the increase in purchase tax, restrictions on hire purchase and the request to the banks to restrain their advances. There was also the setback in the motor car industry and import restrictions in the sterling area.

In addition to open market operations and Bank rate a third method of control has been introduced in Britain, the desirability of which has

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been hotly disputed. In 1939 the Foreign Transactions (Advisory) Committee was renamed the Capital Issues Committee, to which body nearly all forms of borrowing and issues of securities are referred. Borrowings from banks for *ordinary business purposes* do not have to be referred to this Committee, apart from transactions of a capital nature, but the commercial banks have received from the Government directives, suggestions or recommendations (these three words in practice amount to the same thing but more sensitive people prefer one word to another) that bank advances should ordinarily be confined to certain special purposes, for example to facilitate the export trade, agriculture and other industries of national importance. In other words it is a "selective" control, and the banks are asked to look at an advance from the point of view of national interest, and not merely from the standpoint of credit worthiness. The use of this new weapon has been severely criticised both on grounds of principle and effectiveness. There is nothing radically wrong that I can see in suggesting that one form of advance is preferable to another, particularly at a time when the economy may be stretched to its limits. As to its effectiveness I would agree that it is not completely effective or satisfactory but the same objection applies to the other two weapons, open market operations and Bank rate. In a fully employed economy all three weapons may be necessary, and we should not dismiss the possibility of further instruments being forged during the coming years.

I think it must be admitted that whatever criticism there may be against the direct method of selective control, as opposed to the indirect approach of open market operations and Bank rate, it has had its effect. Yet for us bankers it has been painful to administer and the frustration of thousands of branch managers throughout the country has been very great, and, that being the case, it is doubtful whether this policy can be continued indefinitely for it is beyond human nature to expect those who in the last resort have the decision to make, as to whether a customer should have credit or not, to keep up a continuously negative attitude to applications for credit, many of which on their own banking merits would be unchallengeable. At present there is an understanding between the clearing banks that one bank will not entertain an application for credit from the customer of another bank where the customer has been refused credit on the grounds of "credit restraint policy". This understanding between the banks is naturally a limitation on competition and it is a limitation which is highly distasteful not only to the public but to the banks themselves, and all concerned wish it to be abandoned as soon as possible. Therefore, in the final analysis, the real restraint on credit must come as a result of Government policy. If Governments and industry, even for the very best of reasons, indulge in a vast programme of capital expenditure the demand for credit from the banks will increase, and while the central bank might for a time be able to keep this in check by skilful use of the weapons at its disposal the operation can in the long run be only partially successful.

The important point is that considerable discretion should be allowed in the use of these instruments and that they should not be made the subject of statutory regulations. I have already commented on the limitations of open market operations and Bank rate as methods of central bank control, but "directives" imply a more positive relationship which must be set against the background of existing arrangements for informal discussions between the Bank of England and the clearing banks.

The act of nationalisation of the Bank of England which took place in 1946 represented an important constitutional change which has not meant very much change in practice because of the conception the Bank of England already had of its duties, as witness Montagu Norman's view of the duties of a central bank. Nevertheless, to put the matter beyond question an important clause was inserted in the Bank Act of 1946 which permitted the Bank on the authority of the Treasury to issue directives to any banker. In this clause there are certain safeguards protecting the position of any particular customer and also the right of a banker, a commercial banker, to be heard. This same section, too gives the Treasury the power, for the purpose of the Act, to define a "banker". The central bank undoubtedly derives wide powers from this section but powers which in turn derive from the central Government itself.

This statutory power over the commercial banks has never been employed and, indeed, the relationships between the central bank and the commercial banks have long been based on informal discussions. This is due not only to the historical development of banking but to the general development of political institutions in England; it is in fact part of our tradition. In speaking of commercial banks I am confining my remarks to those banks carrying on the day-to-day business of deposit banking. Investment banking, hire purchase banking and even in some respects merchant banking, all of which play a very important part in our economy, really lie outside the scope of this paper. The commercial banks consist chiefly of the eleven London clearing banks, the Scottish banks, the Irish banks and the overseas and foreign banks, all except the foreign banks and some of the overseas banks being linked together through membership of the British Bankers' Association, a body which has no executive functions and very little advisory duties.

The chief constituent members of the British Bankers' Association comprise the Committee of London Clearing Bankers and insofar as there is any authority in British banking it resides in the Committee which has, however, no legal function or executive power. Nevertheless, its decisions are of the greatest importance to the whole structure of banking; its lead is invariably followed and it is the link between the financial community, the central bank and, on appropriate occasions, the central Government as well. And the link it provides is informal and intimate. The Chairman of this Committee (who is usually elected annually but holds office for two years) is consulted by the Governor of the Bank of England continuously, and over the years there has grown up a relationship of mutual respect and understanding.

It is the custom of the Committee of London Clearing Bankers to meet monthly to discuss matters of general interest and broad policy, and four times a year their meetings are held at the Bank of England when the Governor of the Bank of England would also be present. Attached to this Committee is the Chief Executive Officers' Committee consisting of certain senior General Managers from each of the clearing banks. This secondary Committee considers, again usually monthly, all the practical problems with which banking is faced and in appropriate cases makes recommendations to the Chairmen's Committee for decision. The Chief Executive Officers' Committee, too, maintains a close association with the officials of the Bank of England and with the various sections of the money market.

The liaison between the Merchant Banks, or Acceptance Houses as they are sometimes called, and the Bank of England is not unlike that which exists between the Bank and the clearing banks, which is to say that it is carried out principally by informal methods. As could be expected the policies recommended to the clearing banks are recommended equally to the merchant banks, with some allowance being made for the different structures of the two systems. There is some liaison between the clearing banks and the merchant banks but it is very loose, and it is perhaps an advantage that in certain matters lying outside the recommendations and regulation of the central bank there are differences in practice between the two methods of banking. Many of the functions of the merchant banks lie outside the scope of my remarks today but their commercial activity both at home and abroad is highly important. In domestic finance this activity has tended to increase in recent years; for instance, the granting by the merchant banks of what we call "inland acceptances" has played an important part in providing short-term finance for commerce and industry. Under this system the merchant bank places its signature, by way of acceptance, on the bill drawn by the credit taker and the resultant bill finds its way into the money market for discount, and it may ultimately form part of the short-term assets of the clearing banks. Such acceptance credits compete with the loan or overdraft facilities granted by the clearing banks and in normal times it would be the cost of finance which would determine whether a bank overdraft or an acceptance credit would be more attractive: when the discount rate plus the acceptance commission is lower than the rate for bank overdrafts (I have already indicated that this is normally $^3/_4$ per cent. above Bank rate) then the acceptance credit becomes more attractive. But over the last year or two credit has been so scarce and difficult to obtain that the cost of it has not always been the determining factor, but rather the availability at any reasonable price. In the finance of foreign trade the merchant banks play a relatively smaller part than formerly. But any relative decline in external financing has been due not to a lack of enterprise on the part of the merchant banks but rather to a change in the machinery of financing foreign trade. Other institutions have come into a field which was once exclusively the merchant banks' own, and, perhaps more significantly, other countries are financing their own exports and imports.

So far I have been concerned exclusively with British banking but I should like to consider for a moment banking in the Commonwealth, if only because so many overseas central banks have been formed with the aid of the long experience and assistance of Bank of England officials. These Commonwealth banking systems have inevitably developed their own techniques because their economies are different and their commercial banking systems quite unlike that which has grown up in Britain. To quote only one example, the London Money Market is unique because it has two centuries of history behind it; moreover, it is compact, and the size of Great Britain itself makes an informal system so much easier to operate. Therefore, it is not surprising to find that overseas the system has to be more formal.

One major point of difference between central banking in Britain and in the rest of the Commonwealth lies in the power often given to central banks overseas to vary the reserve requirements of the commercial banks. In practice, however, considerable reliance is placed upon the central banks' ability to exercise a direct control over the lending policies of the commercial banks. Moreover, the scope of open market operations is limited by the size of the capital market.

The oldest central bank in the Commonwealth is the Commonwealth Bank of Australia which was founded in 1911, although not until 1924 did it receive full power to control the note issue; steps were taken at the same time to make the management of the Bank as free from political pressure as possible. In general it may be said that the reorganisation of the Commonwealth Bank in 1924 was based on contemporary British experience. During the early 1930's the management of the Bank came under political pressure to adopt "unorthodox" policies, and ultimately, as it happened, the depression forced the Commonwealth Bank along the path of national independence in monetary matters.

After 1945 the Commonwealth Bank was given wide powers to control bank credit, and, moreover, care was taken to ensure that the financial policies of the Commonwealth Bank did not clash with the social objectives of the Government. One interesting development during the war was the introduction of the special deposit system whereby the trading banks were required to put a proportion of any increase in customers' deposits into a special account with the Commonwealth Bank. In essence this system remains a feature of Australian banking, although it is possible that before long it will be superseded by a system of variable reserve ratios. The method of control at present is for calls to and releases from "special deposits" (i.e. "reserves") of the banks with the Commonwealth Bank to be made at the behest of the latter. The operation of the system is facilitated by an agreed minimum liquidity ratio (cash, Treasury bills and Government securities) of about 15 per cent., combined with advice to the trading banks on their lending policies. It may be necessary for any bank to borrow from the Commonwealth Bank at an unfavourable rate if its liquidity ratio, without such borrowing, would have been below the agreed minimum. Subject to the approval of the Government the

Commonwealth Bank is empowered to control the rates of interest payable to or by banks, and since the war it has been official policy to keep interest rates at the lowest practicable level. One unusual point in Australian central banking is the fact that the Commonwealth Bank controls a trading off-shoot, the Commonwealth Trading Bank of Australia. Both are Government-owned, and the latter competes for general banking business with the commercial banks. The Australian Government however now believes this to be an undesirable situation, and accordingly it proposes to sever this connection.

In Canada central banking was not established until the mid-1930's when the depression and the consequent loss of chartered bank liquidity created conditions which gave support to the views of those who had long thought that a central bank was necessary. Until then the Canadian banks had held their reserves in the form of cash or reserves held abroad, and in this way a banking system providing adequate banking services had been able to function. The loss of foreign reserves, and the consequent loss of liquidity, focused attention on the possibilities of currency management, here again British influence was strong. The Bank of Canada was accordingly set up in 1935, at first under private ownership but almost immediately it became nationalised. The Bank of Canada was fortunate in the date of its foundation, because the improvement in world conditions during the later 1930's made the task of a central bank easier, and, possibly in consequence, harmonious relations with the chartered banks were quickly established. The methods of control today are consultation, together with an agreement on liquidity ratios and the ability to conduct open market operations. At present the chartered banks must hold 8 per cent. of their deposit liabilities in cash, but the central bank has the statutory power to raise this minimum to 12 per cent. by steps of 1 per cent. in any month; there is also an agreement that the combined ratio of cash, Treasury bills and call money should be 15 per cent. The Bank of Canada is prepared to make advances to the chartered banks if necessary, but the banks are encouraged to replenish their cash by selling securities or Treasury bills on the market. Advances made to the chartered banks are made for a minimum period of seven days at Bank rate. One interesting development is the practice of the Bank of Canada in keeping its Bank rate at some specified margin ($^1/_4$ of one per cent.) above the Canadian Treasury bill rate. One reason for adopting this procedure is to avoid infrequent and unpredictable changes in Bank rate and the consequent disturbance to borrowers.

The Reserve Bank of India was also established in the 1930's to take over from the old Imperial Bank which had hitherto fulfilled some of the functions of a central bank; the Reserve Bank was nationalised at the beginning of 1949 after India had achieved her independence. In recent years, together with the Imperial Bank which has been converted into the Government-controlled State Bank of India, the Reserve Bank has been playing an important part in India's development plans. Not only does it regulate credit by using all the weapons available to a nationalised central bank, but it also concerns itself directly with the problems of economic expansion, particularly in agriculture.

In furthering the agricultural development of India, the Reserve Bank maintains an expert staff to study questions of agricultural credit, it finances agricultural operations at low interest rates through the medium of the central and mortgage banks and State Co-operative banks, and provides long-term credit against mortgages on land. The State Bank, as part of the general economic development plan, has undertaken to open 400 new branches in the five years ending in 1960.

The usual weapons of Bank rate, open market operations (a bill market was created in 1952 with the support of the Reserve Bank) and compulsory reserve ratios (now varying between 5 and 20 per cent. in the case of demand liabilities and 2 and 8 per cent. in the case of time liabilities) have been re-enforced by very powerful direct controls. Commercial banks must take out a licence with the Reserve Bank which has power to inspect the books of any bank and report to the Central Government who might, if the report were adverse, prohibit fresh deposits and restrict the trading activities of the offending bank. Moreover, the central bank has the power to determine the lending policy to be followed by banking companies, and also to decide the purposes for which advances may be granted and the rates of interest to be charged.

Since the end of the second world war central banks have been established in the less developed parts of the Commonwealth, notably in Ceylon where in 1950 the Central Bank of Ceylon was founded. The Bank has the sole power of note issue, and has the power to require the commercial banks to maintain with it reserves of 10 to 40 per cent. of their demand liabilities and of 5 to 20 per cent. of their time deposits. The Central Bank has the power to vary the required reserves within these limits, and in practice the required ratios have remained at the lower end of the scale. Little reliance is placed on movements in Bank rate. The normally high liquid position of the commercial banks in Ceylon led to authority being given to the Central Bank to fix if necessary very special high cash ratios of up to 100 per cent. for deposits in excess of a predetermined limit. Open market operations have been on a small scale, but last year the Bank made two issues of its own securities in order to reduce the money supply. According to the Bank their short-term issues have proved attractive to the general public, and two-thirds of a recent one-year security was taken up outside the banking system.

So far in this paper I have been largely concerned with the effect on domestic activity of various methods of central bank control but I must consider, too, the impact which the Bank of England has had on the foreign business of the commercial banks. This has been brought about by the powers which the Bank of England obtained through the Exchange Control Act of 1947. The Act served to consolidate war-time regulations introduced in 1939. There is no need for me to describe the objectives of this Act which I feel sure must, in broad outline, be well-known to you although some of its applications may at times be a little complicated and confusing even to those of us in London who as Authorised Banks have to administer the Act. The commercial banks are among the Authorised Dealers who today number more than 100 and practically every bank today is an Authorised Dealer.

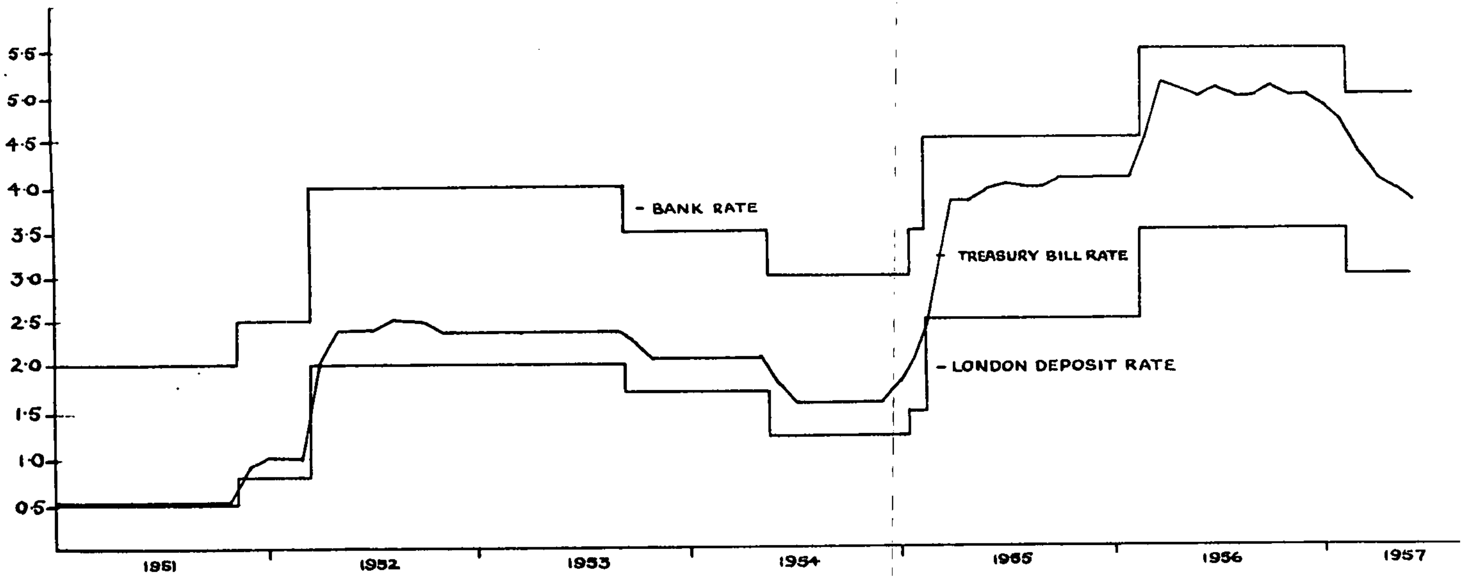
The application of the Act has been considerably liberalised and simplified during the last five years, and if it is admitted that Exchange Control is necessary at all (and I think in the case of the sterling area it must be admitted) then I do not consider that there is very much to be said in criticism of the broad conception of the Control, at any rate as far as the commercial banks are concerned. The banks have considerable authority over a very wide area of transactions and I would say that I am amazed, considering the delicate position in which Great Britain finds itself today with its balance of payments, how free the commercial banks are to conduct their day-to-day overseas business.

Within the Exchange Control system, and bearing in mind official requests to avoid speculative business, the Authorised Dealers are permitted to deal in foreign exchange within wide discretionary limits and to grant short-term credits to their overseas customers according to their judgment, and there is no attempt by the Bank of England to dictate the amount or terms which a credit-giver grants to his customers; that is left to the commonsense and prudence of the banker. I feel sure that this very liberal treatment has resulted in London retaining much of its international banking business, even at a time when, by reason of the partial inconvertibility of the pound sterling, it might have been expected that credit-seekers would have gone elsewhere. It is true that in the last two years a certain amount of business has been lost by London but this is a direct result of the deliberate policy of the authorities in raising Bank rate to set a check on overseas credit in order to strengthen our balance of payments. No obstacles are placed in the way of commercial banks granting credit to finance exports; transactions of this kind are regarded as exempt from credit restraint, and recently the facilities of the Export Credits Guarantee Department have been widened and the Department is now authorised to give direct guarantees to the banks for certain export transactions.

I have given you a very broad picture of the relationships existing between the Bank of England and the commercial banks, particularly the clearing banks, in the United Kingdom. I emphasise that it is a broad picture for I am conscious that I have left out a good deal of detail. I shall, however, be very happy to try to answer any questions you may care to raise during our discussion later. Although I would not assert that present relationships between the central bank and the commercial banks are perfect, there is probably little which could not be put right by a greater understanding of each others' point of view, and indeed, it may be that the recently appointed Radcliffe Committee, which is to conduct an enquiry into the workings of our monetary system, will be able to throw a little more light on some of the darker corners of banking both commercial and central. A fuller and franker exchange of information on the part of the Government and the central bank on the one hand, and the commercial banks and, indeed, the public as a whole on the other, would seem to be desirable. It must surely be realised that the fight against inflation is many-sided and concerns not only the Government and financial institutions but industry and the trade unions as well. The fuller and franker the relations between the Government, the central bank and the commercial banks can be, the better will be the chances of success in the monetary field, which is my main concern today. Wisdom may not always lie with majorities but none of us should make that an excuse for adopting an aloof or authoritarian attitude; an understanding is more likely to be found in intelligent co-operation.

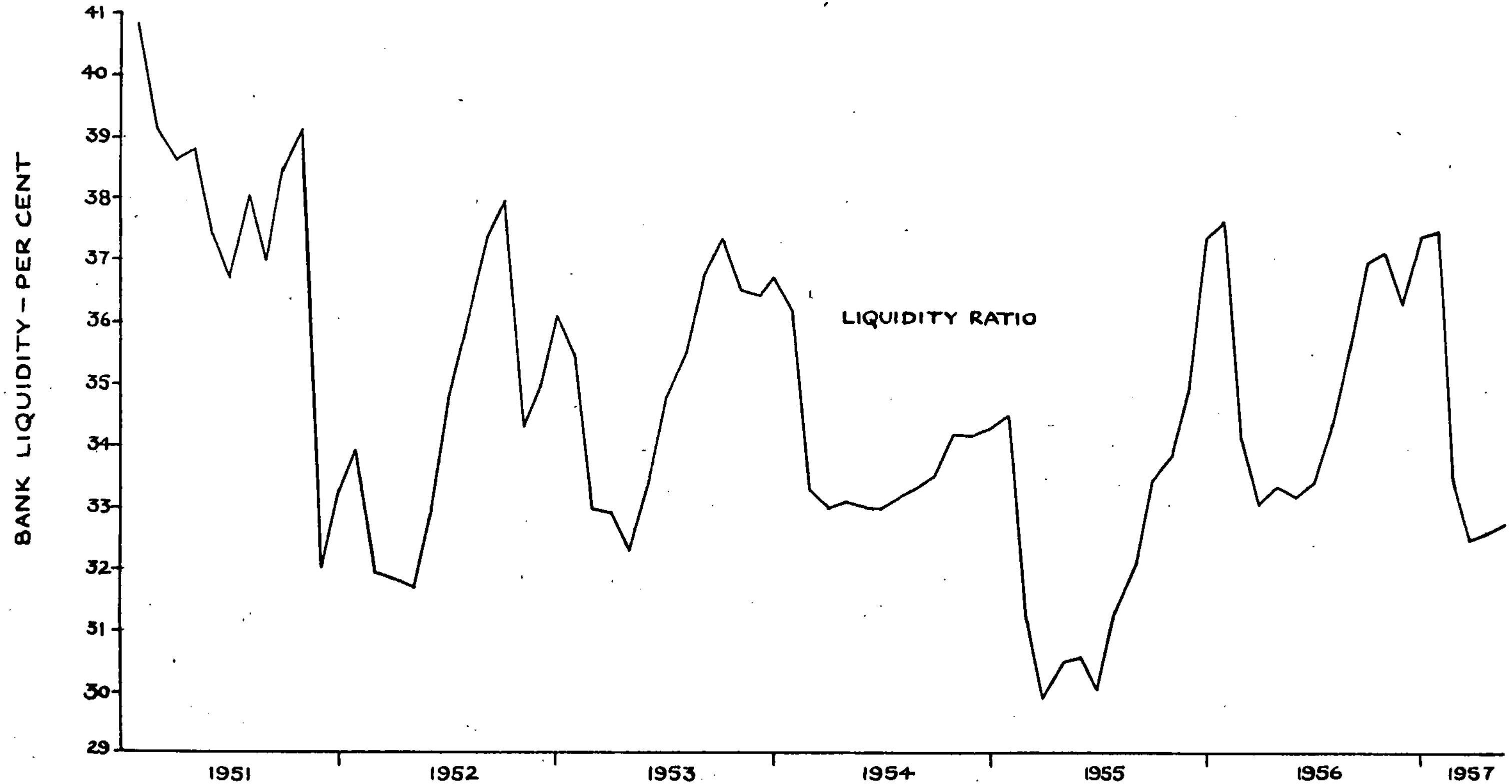
INTEREST RATES

Abb. 1



BANK LIQUIDITY RATIOS

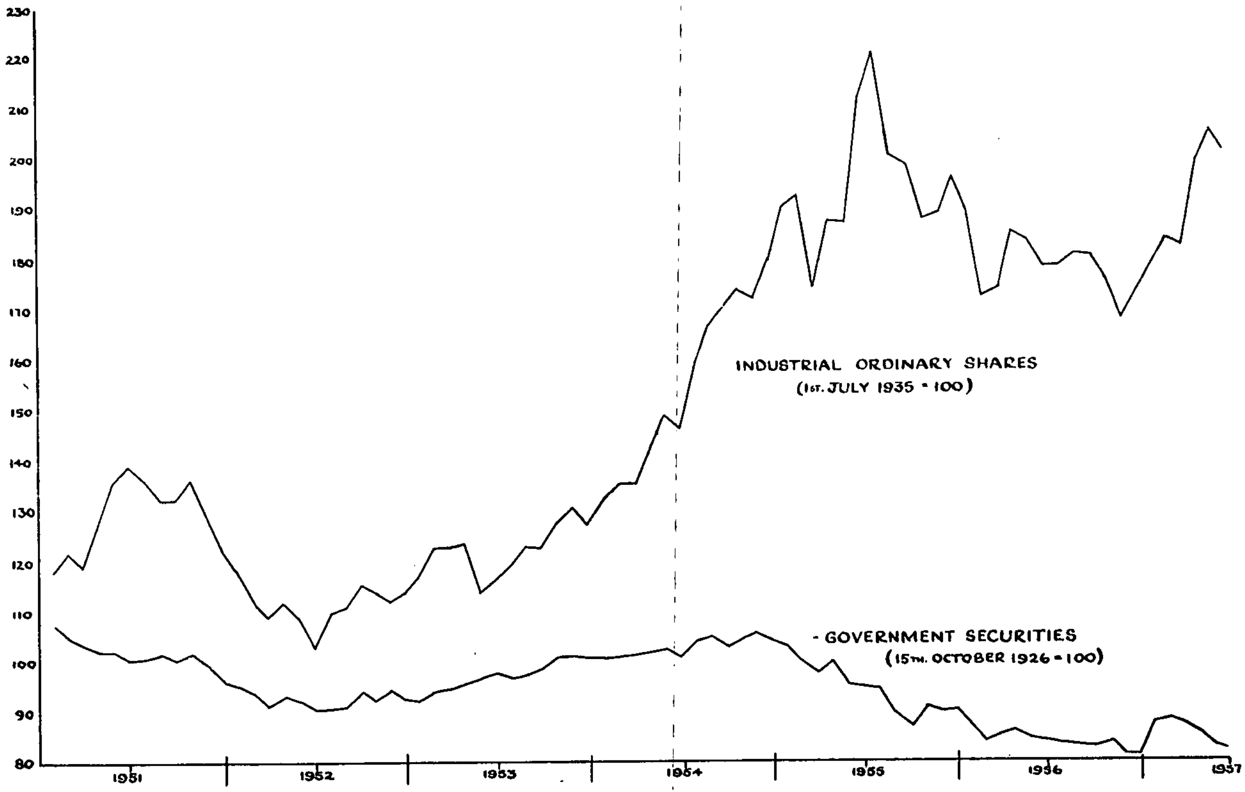
Abb. 2



RATIO OF CASH, CALL MONEY AND BILLS DISCOUNTED TO GROSS DEPOSITS

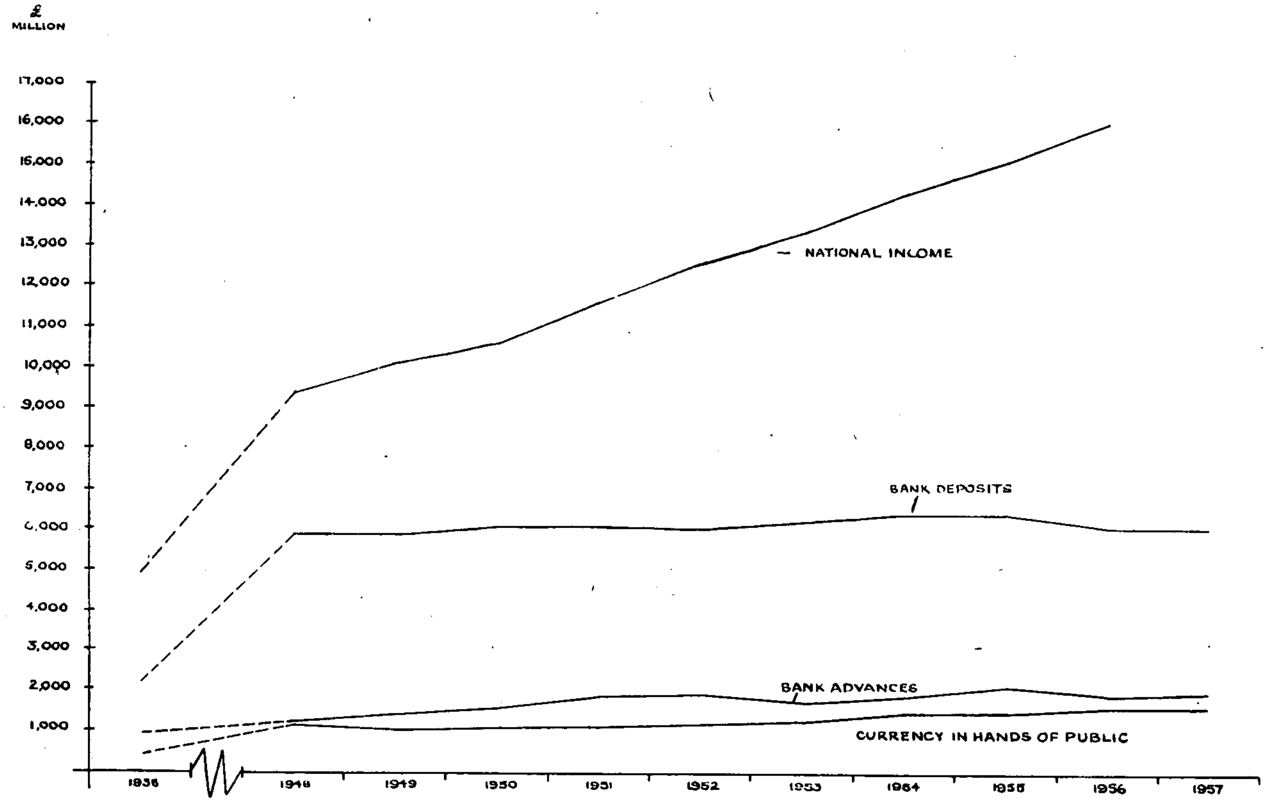
STOCK EXCHANGE PRICE INDICES

Abb. 3



NATIONAL INCOME AND BANK DEPOSITS AND ADVANCES

Abb. 4



CREDIT CONTROL AND THE CLEARING BANKS*

William Manning Dacey

The overriding subject of this series of lectures is "The Credit Squeeze". Like previous speakers, however, I propose to broaden our horizon and to discuss not just our experiences during the last twelve months or so but the general principles of credit control. Once the economy has got into a really inflationary situation, with an emergency in the balance of payments, almost any device may be preferable to the alternative of just letting the inflation rip. In the long run, what is of importance is to agree upon an approach to questions of monetary control that will help to prevent such a situation recurring.

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One of the subjects of controversy over the past twelve months has been the question whether, in fighting inflation, it is more effective for the authorities to operate on deposits or on advances. To a large extent, this is a false antithesis: for if the authorities are able to bring about a reduction in deposits this must sooner or later induce more restrictive lending policies on the part of the banks. Yet in the earlier months of 1955, especially, attention seemed to be focused almost exclusively on the movement of advances. The fact that in the first half of 1955 the clearing banks sold some £250 millions of investments, so that the underlying trend of deposits was falling steeply, was regarded as of no account compared with the fact that advances at that time were still rising.

The case for looking primarily at advances turns mainly on arguments about velocity of circulation. If a bank makes an advance, it is argued, this injects money straight into investment and into the business circulation, and necessarily generates incomes. The sale of investments, on the other hand, will only mop up more or less idle balances in the financial circulation. Hence even though the rise in advances is offset by an equivalent fall in investments, so that deposits are unchanged, their velocity of circulation will have risen.

I think that on balance this is true; but it is definitely a question of a balance. On the one hand, not all advances do inject money into the income circulation: bridging operations, for example. On the other hand, I am sure one cannot extinguish large amounts of bank credit through the sale of investments without having some effect on the level of spending, if only because this must tend to raise the long-term rate of interest.

In my view, the amount of income-generating activity which is going on is not determined, in the main, by whether the banks are following a restrictive or a generous lending policy. It is determined far more by the amount of liquid assets (which in this context means primarily the amount of bank deposits), in the possession of the public. For

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*Lecture before the Institute of Bankers, London, Nov. 29, 1956. Reprinted by permission of author.

purposes of economic analysis, it is often useful to draw a distinction between the business circulation and the financial circulation. But this should not mislead us into supposing that in practice there is any rigid compartment between the two. On the contrary, the normal process by which the national income circulates implies that there will be a constant interchange between them. All the time, some part of current income is being saved and so finds its way—conceptually at any rate—into the financial circulation, while at the same time other funds, temporarily in the financial circulation, are finding their way back, via the new issue market and other channels, into active employment.

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Nevertheless, I have already admitted that a rise in advances does tend to mean an increase in velocity of circulation. Even so, there is still, to my mind, only one state of affairs which justifies treating bank lending as on a different footing from lending by any other persons or institutions. That state of affairs is if the bank lending involves an expansion in deposits, if it results in an increase in the stock of money. Only if that is happening is the position of the banks fundamentally different from that of any other lender.

Let us suppose that the total of outstanding advances is exactly stable, neither rising nor falling. What this really means is that the banks are utilising the current flow of repayments from existing borrowers to finance a fresh set of advances. This is surely no different in essence from what takes place if customers of the banks decide to place funds with building societies or hire purchase finance companies, or if an insurance company uses part of its premium income to buy industrial debentures. In each case the lender—whether it is a clearing bank or a private person or company—is simply putting back into circulation again money which was already in existence. Nor is there any fundamental difference if advances are rising but the increase is offset by compensating sales of investments, so that deposits are unaffected. Once again, existing money is being put back into circulation. In this case, the funds are drawn not from the repayments of borrowing customers; they are drawn from other depositors who are relinquishing their balances in exchange for securities.

Undoubtedly, this process is likely to result in some increase in the average velocity of circulation of an unchanged volume of bank deposits: to put money to active use is, after all, the purpose of all lending and borrowing. But any case for restricting bank lending which is based on velocity considerations applies in principle just as much to lending by any other party. Provided the rise in advances does not mean an expansion in deposits, then the bank lending is simply channelling into active use money which was already in existence. And let us note that this always will be the position if the authorities are doing their job properly; for if they are in control of the situation they will always be able to prevent an undesirable expansion in deposits.

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However, let us suppose that the flow of spending is rising to inflationary levels. The orthodox remedy, of course, is to bring down the level of bank deposits. As Professor Paish showed, and I shall return to the subject later, this implies that the authorities must feed

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out long-term securities which are taken up by the public, so that funds are syphoned away from the banks.

This method seems to me to have three great advantages. First of all, there is no interference with anybody's liberty: the authorities merely exercise persuasion, through the offer of more attractive yields, to induce the owners of part of the existing stock of money, to exchange their balances for long-term securities. Secondly, this process will at some stage exert a restraining influence on bank lending policies but with two important difference as compared with lending directives: (a) if advances are declined, they will be declined on banking considerations; (b) the restriction on bank advances will be only one aspect of a general and all pervading financial stringency, and so is less likely to be neutralised by resort to alternative methods of finance.

It may be objected that this method takes time, that some months may elapse before the reduction in deposits does affect advances policy and that conditions at the time may not be conducive to the issue of long-term securities. I shall argue later that this probably does not matter. In any case, an inflationary situation does not really blow up over night. The average rate of turnover of bank deposits was rising in every single year from 1947 to 1955—it rose on balance from thirteen times to more than twenty-three times. Yet, in 1953 and 1954, the volume of bank deposits, so far from being reduced in order to offset this rise in velocity due to boom psychology, actually rose; and as the gilt-edged market was also rising all the time, there could be no question of inability to feed out long-term issues. I think most people now would be prepared to agree that the credit expansion of 1953 and 1954 was a mistake, and in no small degree responsible for the difficulties of 1955.

However, I would agree that, as the situation had developed by July 1955, the authorities probably had not much choice but to issue the directives they did. It is true that at the end of June, the combined liquidity ratio was scarcely above the famous 30 per cent. mark. Yet in each month of the second half of the year the liquid assets of the clearing banks rose substantially. By the end of the year they were actually more than £500 millons higher than they had been on June 30. And the imminence of that expansion in liquid assets, if not its actual magnitude, cannot have been entirely unforeseen, either by the banks or by the authorities.

But if the directives were justified as being the lesser evil at the time they were introduced, I do not think we can feel that a really healthy monetary situation has been restored until these particular restraints have become unnecessary. The mere existence of the directives is a tacit admission that there is too much money about; the directives themselves are an attempt to place obstacles in the way of that money being used. It seems to me far more satisfactory as a long-term policy to remove the excess and allow the economy to function freely.

By far the most important objection to the directives method, I think, is that if advances are to be declined on other than banking grounds, then some restraint upon competition between the banks becomes unavoidable. Clearly, a credit squeeze of this nature—as distinct from a liquidity-induced squeeze—would be quite unworkable if customers refused an advance were able to play off one bank against another. Then, I personally feel very doubtful whether the concept of the "national interest" has any real meaning as applied to the great mass of individual accounts.[1] Admittedly, at one extreme we can accept and act upon the principle laid down by the government that certain things are contrary to the national interest, such as speculation and hire purchase. At the other extreme, we can accept and act upon the view that certain major export industries ought to be encouraged. But in between, over a very wide range, it seems to me, the picture becomes blurred and judgments can only be arbitrary. I was told of one case in which a branch manager reported that he had given an advance to a window-cleaning firm because they were cleaning the windows of a factory engaged in exports. I think logic was on the side of the branch manager.

I am sure it is a source of strength that in times of emergency the clearing banks can be relied upon to act with a due sense of responsibility and seek to interpret the national interest to the best of their ability. One may even feel that the pattern of advances that has emerged during the squeeze is by no means unreasonable. Nevertheless, I should not think it a good thing if this came to be regarded as part of the normal method of running our economy. My personal preference is to leave the allocation of resources to be decided normally by the judgments of the market place—which means by the collective decisions of the whole community, spending and saving and investing as they—and not Authority—think best. But that can only be if the authorities first create and maintain the right kind of general economic environment. It means that we must have a long-term rate of interest which holds the right balance between saving and investment; and it means that we have to keep a tight rein on the supply of money, so that domestic demand does not become excessive, the economy is not over-burdened, and production for export is at least as profitable as production for the home market. If those over-riding conditions are satisfied, then there will be no need for priorities or for attempts by artificial means to divert resources towards investment and export.

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One other lesson of the last few months does seem clear to me. It is that, if we are to have directives, it is a mistake to allow these to be expressed as an arithmetical target. I am not referring here to the merely statistical fallacies—the impossibility of deducing from the monthly published figures the week to week progress of the credit squeeze. I have in mind the impossibility of knowing in advance precisely what the arithmetical effect on advances will be of acting upon a given set of principles.

There are at least two major difficulties. First, we can have no knowledge in advance of what the demands of the priority categories are likely to be. Secondly, we cannot know how a given reduction in limits for other borrowers will react on their actual borrowings. In some cases a reduction in limits may well be offset by an increase in the utilisation percentage. It seems to me that the overdraft system, which is now virtually universal in this country, makes it particularly

[1] See Sir Theodore Gregory, Stamp Memorial Lecture for 1955.

difficult to operate a credit squeeze of this kind with any precision. We all have a few bees in our bonnets and I have sometimes wondered whether it might not be an advantage if we were to adopt the practice, followed in some countries, of charging a commission when granting an overdraft limit. Such a charge would surely be fully justified, since from the point of view of the customer an unutilised overdraft limit is almost as good as an actual credit balance and at present costs him nothing. The advantage I have in mind, regardless of any revenue it produced, is that such a charge might help to cut out a certain amount of dead wood in outstanding limits. The total of outstanding limits, if people were paying for these facilities, would begin to have some significance. And an upward variation in the commission charge might make it easier to negotiate reductions in limits should yet another squeeze have to be imposed at some future time.

The classified figures of advances, I think, help to illustrate the point I have made above about the difficulty of knowing in advance what will be the arithmetical effect of any given policy. Taking the published quarterly figures, we see that total advances over the twelve months to August 1956 declined by just on 7 per cent. This overall decline, however, was the resultant of some very diverse movements.

In terms of money, about half the total contraction was accounted for by the Personal and Professional category, which fell by more than 17 per cent. The remaining groups together fell by only about 4 per cent., but this in turn conceals some very divergent trends. Thus, there were four industries which actually increased their borrowings over the period, namely iron and steel, engineering, shipping and chemicals. Altogether, the outstanding advances of these four groups rose by about 25 per cent. over the period. The other fifteen trade and industry groups, on the other hand, showed a combined fall of between 9 and 10 per cent. Agriculture, although accorded a preferential position, was among this declining group with a fall of about 6 per cent., no doubt because repayments of pre-squeeze lendings for capital purposes were more than offsetting new lending for current purposes.

The largest single contraction was that of £28 millions—15 per cent.—for the retail trade category. I find it interesting to note that, in spite of this quite severe reduction in bank accommodation for retailers, the value of retail sales in August 1956 was actually 11 per cent. higher on the year and for the whole period May to September was 6 per cent. higher. Clearly, the withdrawal of bank credit has not made it impossible to finance a larger turnover. And this has occurred in spite also of the sharp reduction in personal loans, in spite of a drop of no less than 44 per cent. in loans to hire purchase finance companies and of quite a severe recession on the Stock Exchange—all things which might at first sight have been expected to have an adverse effect on retail turnover. One suspects that the effects of the credit squeeze on the economy—on such things as the level of inventories, the distribution of manpower and the total of personal spending—might have been greater if the decline in the underlying level of bank deposits in progress up to the first quarter of this year had continued instead of being partially reversed, as it has been.

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There is one further point I should like to make about the credit squeeze, if I may be permitted a digression. The sharp decline in the personal and professional category has led some people to suggest that the squeeze has borne more hardly on "the little man"—the little man obviously being identified with the personal borrower. This was not confirmed by an analysis recently made of the behaviour of a group of debit accounts in my own bank over the twelve months to June 1956.

The sample taken comprised more than 800 accounts drawn from about a score of branches scattered over the country. The branches were selected on a basis that seemed likely to be reasonably representative of our domestic business as a whole, while the choice of the proportion of accounts taken from each branch was a random one. In one respect, this sample was undoubtedly too small to be fully representative; namely, as regards the larger accounts, which represented in number only 3 per cent. of the whole. My remarks will therefore be confined to the 97 per cent. of the whole sample with limits below that figure.

More than half of these—that is, well over 400—fell into the smallest category taken, namely accounts with limits not exceeding £1,000 in June 1955, and just about two-thirds of these were personal accounts. Over the twelve months to June 1956 the combined limits of these small accounts were reduced by only about 1 per cent, and their total borrowings fell by less than 5 per cent. By contrast, the combined limits for the remainder (those with limits above £1,000 in June 1955) were reduced by more than 10 per cent. and their actual borrowings fell by 18 per cent.

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To return to our main theme, I think I have said enough to indicate that, in my view, monetary control ought not, in the normal course, to operate directly on advances but should have regard to the level of deposits. This brings us to the many complex questions, with which the rest of this lecture will be concerned, concerning the regulation of deposits.

All of us were brought up on the classical syllogism: the banks maintain a fixed ratio of cash to deposits; the central bank controls the supply of bank cash; therefore the central bank controls the volume of bank deposits. Until recently, it seemed impossible that so apparently watertight an argument could ever be challenged. Yet it has in fact been brought into question, and for the reason that the second proposition—that the central bank controls the supply of bank cash—is no longer self-evidently true under modern conditions.

Before going any further, I think I should emphasize that nobody ever supposed the central bank could reduce the supply of bank cash—the level of bank cash reserves—simply by open market operations. We have always known that if the cash reserves of the banks were reduced by an open-market sale of securities, the immediate and natural reaction of the banks would be to seek to replace at least part of that from their secondary reserves: in our system, typically by calling in short loans from the discount market, which in turn finds the required cash by borrowing from the central bank. What gave the central bank control over the supply of bank cash was the secondary repercussions of this process. Short term rates would rise and this would reduce the amount of eligible paper coming forward: the banks would become short of secondary reserves. So at some stage, the contraction in bank cash brought about by open market operations would cease to be offset, or fully offset, by discount market borrowings from the Bank of England.

But this means that the traditional mechanism never did operate simply in terms of the supply of bank cash. It operated through the total amount of eligible paper in the system. So long as the clearing banks have sufficient liquid assets in total—cash plus secondary reserves—to maintain a given volume of deposits, without their liquidity ratio falling below what is regarded as the working minimum, there need be no contraction in deposits. Deposits have to fall only when the supply of total eligible paper itself is reduced, so that the banks can no longer maintain the former volume of deposits without their liquidity ratios falling below the working minimum. In other words, the traditional mechanism, although it was described in terms of the supply of bank cash, really operated through the supply of total eligible paper: through liquidity ratios, not the cash ratio.

Now, the basic principles of our particular system were definitely laid down by Bagehot in 1873, when he rationalised the policy actually followed by the Bank of England in 1866. For long, these principles have served us well. R. V. Roosa, for example, in his recent study of Federal Reserve Operations, says: "London has long been regarded as the classic money market for domestic needs, for international requirements and for furnishing the central bank with a suitable milieu in which to exert its influence with reasonable assurance of a prompt sensitive and general response." Unfortunately, Bagehot not only invented the term "lender of last resort" and stressed the importance of that function as the essential duty of a central bank. He also invented a thing called the Treasury bill; and perhaps the most important fact in our monetary situation today is that the Treasury bill has for practical purposes superseded the commercial bill of exchange. We have to adapt our thinking to that fact.

The so-called Bagehot doctrine maintains that the central bank must never seek directly to ration borrowers but must be prepared to adance without limit against all eligible collateral brought to it. The central bank must be an "automatic" lender of last resort without prescribed limits, not a discretionary lender.

How, then, is the central bank to ensure that any action it may take to restrict credit is not completely neutralised by demands made upon it for credit which it cannot refuse? To ward off excessive applications, the doctrine runs, the central bank must rely mainly upon the weapon of Bank Rate: "Through rediscounting, the central bank allows the competitive banks to take the initiative in procuring additional currency, and they are thus in a position to adjust the supply of currency to the credit structure. The central bank has to keep control of this channel for the supply of currency by modifying, as circumstances may require, the charge to be made for rediscounting".[2]

Now, the preponderance of the Treasury bill introduces several difficulties. The first is this. Whereas an increase in rates could be relied upon to bring about a contraction in the supply of eligible commercial

[2] Hawtrey: Art of Central Banking.

paper, that is not necessarily true of the supply of Treasury bills. Of course, some people would argue that a rise in the Treasury bill rate to really penal levels would induce the Government to resort to other forms of finance. Unfortunately, really penal short-term rates do not provide a favourable background to the floating of long term loans. Even so, it will be argued, a rise in rates will make Treasury bills more attractive to holders other than banks. It will therefore reduce the liquid assets of the banks by reducing the proportion of the Treasury bill issue in their hands, even if the total issue itself is unchanged.

In some banking systems, I think that is true. In the United States, for example, there is a wide and elastic market for Treasury bills, more than four-fifths of the total issue is now held outside the banking system and quite a modest rise in rates will stimulate non-bank demand. Conditions here, in my submission, are different. It is not the absolute level of the Treasury bill rate which appears to be significant but the differential between that rate and deposit rate. Normally, Bank Rate, the Treasury bill rate and deposit rate tend to move in unison, so that the differential between Treasury bill rate and deposit rate is not affected. The big switch in Treasury bills from the banks to non-bank holders took place in the early months of 1955. But at that time an ineffective Bank Rate was replaced by an effective one; formerly, bill rates had been about 1½ per cent. below Bank Rate and they moved up to within ½ per cent. of it; the differential with deposit rate improved by about 1 per cent. in favour of the Treasury bill. No similar large-scale switching of bills from the banks was observable when Bank Rate rose from 4½ per cent. to 5½ per cent. this year.

However, the real objection to the argument that anything can be solved by a stiff enough rise in rates is that it ignores one of the important facts of life. This is that the cost of an increase in Bank Rate now bears very heavily upon the Treasury itself, not only in its effects on the domestic budget but also on the balance of payments. Hence, the realistic assumption, in my view, is that Bank Rate never will be used in the prompt and drastic fashion which alone could make it successful in checking a runaway boom.

The retort may be made that the cost of a short sharp rise in Bank Rate to truly penal levels would ultimately be less than that of a half-hearted and therefore long drawn out credit squeeze. That may be true. But the likelihood of Bank Rate in fact being used in that uninhibited way is perhaps indicated by Mr. Macmillan's observation at the Mansion House dinner, when he said that "there is in practice, if not in theory, a limit beyond which the rate for money could not be driven." Of course, there is room for discussion even about the practicable limit. In Finland, for example, the rediscount rate has recently been 11 per cent., and the central bank wanted to raise it to 13 per cent.[3] However, one imagines that the limit the Chancellor had in mind is somewhat lower and most people would agree. Finland is presumably not saddled, as we are, with a huge burden of external debt in short-term form.

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[3] T. Junnila, Kansallis Osake Pankki Review, No. 3–56.

To summarise the argument up to this point; I have tried to show that Bank Rate can no longer be relied upon to perform one of its most important classical functions, probably the most important of all. Before we conclude that Bank Rate has lost its potency entirely, however, we must consider some other aspects of the question.

There is, for example, the point that overdraft rates are geared to Bank Rate. I think most of us in the City would accept Professor Paish's view that a rise in rates, within the narrow range which seems to be practicable, cannot be expected to have much deterrent effect on borrowers, certainly not in a boom atmosphere. I personally would accept Professor Paish's view that Bank Rate nowadays does not have very great effects in attracting short-term funds to London from the outside world, or in keeping them here, though one must, of course, remember what may be called the "incantational effect" of Bank Rate changes on the outside world. That seems to be the biggest obstacle in the way of bringing Bank Rate down until conditions for sterling are more favourable again.

However, there is one further point which deserves serious consideration. It has been argued, notably by Mr. W. T. C. King, that a rise in Bank Rate will drive up yields on short-term bonds and depress their prices; this will make the banks unwilling to sell short-term securities in order to finance an increase in advances and will also induce them to maintain abnormally high liquidity ratios.

It should not be supposed that this is the present position. Certainly, liquidity ratios are abnormally high. But, if liquidity ratios were to fall, it would not be for the purpose of increasing advances, since these are regulated by the advances directives. It would be for the purpose of increasing the investment portfolio. And the presumption is, that if the banks did enter the bond market on a large scale, their buying would be offset by sales on the part of the government departments, who would use the proceeds to redeem Treasury bills.

Hence the only effect of this operation would be an increase in the banks' investment holdings and a fall in their liquid assets; all that would happen would be a switch within the balance sheets of the banks, with no effect on the level of deposits at all. I am puzzled when I find the financial press referring nowadays to the dangers of high liquidity ratios. It seems to me that, however high liquidity ratios may be, this has no inflationary implications whatever so long as advances are controlled by directives. What is true is that a switch from bills into bonds would help to bring nearer the day when the authorities can safely remove the advances directives.

However, let us consider the normal situation, with no advances directives in force. The argument is that a fall in the price of short-term bonds, brought about by a rise in Bank Rate, will tend to have some restraining effect on lending policies. In an article in the American Economic Review, Professor Warren Smith states that, in the United States at least, "recent experience indicates that rising interest rates do not seriously deter commercial banks, which commonly hold large portfolios of short-term government securities, from selling such securities to meet a rising demand for loans . . . Not very much confidence should be placed in the so-called 'freezing in' effect." British conditions may be different. Even so, it seems clear that any deterrent effect cannot be more than very temporary. All the time, bonds will be approaching their redemption dates. And once the effect of the decline in prices has worn off, one still has to deal with the problem of a supply of liquid assets more than sufficient, by definition, to support the existing volume of deposits. If we are concerned with the long view, therefore, it seems to me that we come back once again to the supply of liquid assets as the basic factor governing the volume of deposits.

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If all this is accepted, it does seem that Bank Rate is not what it was. Many people have drawn the conclusion that radical changes are therefore needed in our system in order to place the monetary authorities effectively in control of the situation. Various strands of thought may be discerned.

First, there is what may be called the Heath Robinson school. A great deal of ingenuity has been devoted in recent months to methods of enabling the authorities to inject an excessive supply of short-term paper into the system, and then neutralise the inflationary implications of this by imposing some fresh restraints on the banks. The proposed restrictions are given a variety of names: variable liquidity ratios, Treasury deposit receipts, forced fundings, and so on. Under whatever name they all come down essentially to the same thing. The banks are to be induced to buy what is nominally a liquid asset, a Treasury bill, and subsequently are to be told that part of their holdings of these so-called liquid assets are in fact frozen solid.

In fairness, it must be admitted that devices of this kind find a place in the armoury of some quite respectable central banks overseas. Nevertheless, I am convinced that the cure for inflation does not lie in the field of technique but in the field of policy and, indeed, ultimately in a country's climate of opinion. I have said elsewhere, and still believe, that if policies are sensible the existing machinery will give sensible answers. It would seem to me a pity to effect radical changes in the system in order to make it easier to follow dubious policies. It is reassuring to note from the speeches at the Mansion House a few weeks ago that these proposals appear to have been rejected.

Then there are those who draw the conclusion that we ought to put the clock back and reverse the Bagehot doctrine that the central bank must be an unlimited lender of last resort. This, of course, means abolishing the discount market, at least in its present form; for so long as call money is to be a truly liquid asset for the clearing banks, no restriction can be placed either on the freedom of the banks to withdraw their money from the market, or on the freedom of the market to obtain the funds it needs from the central bank.

The argument, however, is that the unique institution of the discount market, so far from rendering our system superior to that of other countries, has become under modern conditions a source of weakness. It would be better, the argument runs, if our system were one in which the banks, when they find themselves short of cash, had to apply to the central bank for rediscounts. In that case, if the central bank thought that excessive use was being made of rediscount facilities, it could admonish the member bank in question and in the last resort refuse further facilities. R. V. Roosa, for example, stresses that:

The use of the "discount window" by member banks is, of course, a privilege that is not to be abused or over used * * *. The "discount window" is not a loophole in the Federal Reserve System's credit control apparatus.

My friends in the discount market will be glad to know that, in my view, this line of argument misses the essential point. The point is that, if the secondary reserves of the clearing banks consist of Government paper, there may be no need for them to apply to the central bank for rediscount facilities at all. Over a period, any shortage of cash could be made good by allowing holdings of Treasury bills to run off. In other words, the Treasury, instead of the banks or the discount market, could be put in the position of having to do the borrowing from the central bank, as does sometimes happen over the turn of the year.

The really fundamental question, therefore, is whether the central bank is or is not prepared to take up any Treasury bills which the market is not willing to subscribe. If it is, then open-market operations may be quite futile, as I have sought to show in detail elsewhere.[4] The central bank will be forced to create cash in exchange for Treasury bills, and the particular channels by which that cash reaches the banks are a matter of indifference. In other words, the particular institutional arrangements in force in any country are of very little significance. Whether a central bank is effectively in control of the situation does not depend upon its power to ration rediscounts; it depends on whether it is or is not committed to supplying the Government with short-term finance.

At this point we are tempted to follow another train of thought and to suggest that we ought to put the clock back in another respect: namely, by restoring real independence to central banks and relying upon them to exercise some measure of discipline over Treasuries. To many, this is an attractive vista: but, of course, it is no more realistic as applied to this country than the idea of a 20 per cent. Bank Rate.

What we must hope for, I think, is for the Treasury to recognise that it is its own policies which ultimately govern the supply of money, that if the Treasury is relying too heavily on floating debt finance this can make it difficult or even impossible for the central bank to discharge its obligations. Sir Theodore Gregory, in his Stamp Memorial Lecture, discussing what may be called the golden age of central banking, says:

I should not put the emphasis so much upon the absence of regulation and the freedom from political interference, as upon quite a different circumstance. I mean the existence of a common climate of opinion in governmental and in central banking circles.

And again:

Central banking operations, like Treasury operations, are a continuous day to day matter and the relations between the central banks and the Treasuries must equally be continuous, intimate and based on mutual respect and understanding.

The proper solution seems to me very obvious and very simple. It is simply for the Treasury to refrain from doing too much of its borrowing in short-term form. It must recognise that Treasury bills are the foundation upon which the whole superstructure of bank

[4] The Floating Debt Problem. Lloyds Bank Review, April 1956.

deposits is erected, so that it is the Treasury's choice between long-term and short-term borrowing which ultimately determines the size of the stock of money. In other words, it is now funding policy which is the key regulator of the banking system, not the actions of the central bank in operating upon bank cash reserves.

All this, I think, is completely in accord with what Professor Paish was saying a fortnight ago. He too was placing his faith in a proper funding policy, even though he tried to make our flesh creep by suggesting that Consols might be put on tap at 40. I do not thing an adequate funding policy implies anything quite so ruthless. Of course, if an undesirable credit expansion has been allowed to go on unchecked for some years, so that you have got into a real inflationary boom, quite an abrupt change in the long-term rate of interest may be needed to put things right. But in the ordinary way funding policy should be a continuous and almost imperceptible process. In normal times, the most striking feature of the long-term rate is its stability. At any particular time, the gilt-edged market will have a very definite view about the future norm of prices, and quite a minor fall in prices below that norm will usually attract substantial buying. Indeed, there is one school of thought about the trade cycle which regards this inflexibility—the difficulty of bringing about a really sharp rise in the long-term rate—as one of the main obstacles to preventing a boom. The argument is that, by the offer of only slightly higher yields on long-term securities, industry will be able to tempt into active employment large amounts of hitherto inactive balance.

The difficulty seems to me unreal. The authorities, for their part, will equally be able to tempt large quantities of money out of existence altogether by the offer of funding issues. And if a large contraction can be brought about in the volume of money by the offer of only slightly higher yields, so much the better.

In any event, the possibility of implementing a funding policy does not depend on the readiness of the public to take up funding issues on a large scale. If the market is not absorptive, then, as Professor Paish showed, a small amount of funding will cause a sharp rise in yields, and this rise in the long-term rate will give the disinflationary effect which is desired. On the other hand, if the market is receptive, quite a small rise in the long-term rate will make it possible to fund a large volume of deposits, and you get the disinflationary effect that way.

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One final point about the pattern of interest rates. Professor Paish made it clear that it is the long-term rate we must rely upon to keep saving and investment in equilibrium. He expressed the view, with which I agree, that the short-term rate, within the narrow range of fluctuation possible in practice, cannot be expected to have much effect on the level of activity. But he did not go on to pose the question, which seems to me important, whether if that is so there is any point in raising the short-term rate at all.

Indeed, his exposition may have left the impression that under any conditions the short-term rate is bound to fluctuate fairly widely, above and below the long-term rate. The point I wish to make is that this pattern emerged from a consideration of the alternatives open to private lenders and borrowers in a situation where a major change in the long-term rate is foreseen with a confidence amounting to certainty. This reasoning cannot, in my view, be invoked to explain the behaviour of the Treasury bill rate.

The basic difference is that Treasury bill borrowing, under the conditions we have become used to in this country, is equivalent to the use of the printing press at one remove. Let us suppose that the Treasury decides to do less of its borrowing in long-term form and to raise more by means of Treasury bills. This will tend to bring down the long-term rate; but it will not, except in the very short run, force up the Treasury bill rate. The reason is that, as the banks' holdings of liquid assets are increased, they will tend also to expand deposits. The volume of deposits will be adjusted to the increased supply of Treasury bills, so that the clearing bank demand for Treasury bills cannot, except very temporarily, be glutted.

If short-term finance took the form of actually printing currency, it would be obvious that there would be no tendency for this to force up short-term interest rates. When the process takes the form of issuing Treasury bills and expanding bank deposits, this does not fundamentally change its character.

Conversely, if the Treasury decides to do more of its borrowing in long-term form this will tend to push up the long-term rate but is likely to be accompanied by a downward drag on the short-term rate, because it is a shortage of liquid assets that will be the operative factor in bringing about a contraction in deposits.

Professor Paish showed that the cost, even of the quite ruthless funding policy he was advocating, would be relatively slight. I think he might also have taken credit for a substantial saving in Treasury bill interest.

THE BANK OF ENGLAND*

The unequivocal conclusion from the Parker Tribunal that there is no justification for allegations that information about the raising of Bank rate last September was improperly disclosed by any person will do much to restore the City's self-confidence and the regard of overseas financial centres in its probity. Both are needed. Some of the mud slung at the City from Westminster will, unfortunately, stick; it is altogether improbable that the man-in-the-street's view of the City as a place where people in the know do well for themselves will be conclusively changed by the report. The handling of money is not well regarded these days, and the City as a whole has neglected its opportunities to explain itself to the ordinary man. The small investor and the small bank customer feel remote from it—and that is, to a large extent, the City's own fault and perhaps a fault too late fully to remedy. In evidence before the tribunal transactions by no means extraordinary took on the quality of esoterica and that, to most uninformed opinion, is a patent reason for suspecting them.

No matter has aroused more public concern than the apparently invidious position of the independent directors of the Bank of England. It is most satisfactory that Lord Kindersley and Mr. W. J. Keswick have been so clearly absolved from any allegation that they disclosed, either intentionally or unintentionally, any information about the increase in Bank rate on September 19th. Both knew of the possibility, and both knew later of the provisional decision to increase it. Both were involved in decisions affecting the interests of their companies where a slip—much less than a deliberate false step—would have put them on the wrong side of the line of propriety. Both emerge, after the most strenuous test before the tribunal, free of the least suggestion even of inadvertent misbehaviour and therefore entirely clear of any charge that they might have used information gained as directors of the Bank of England for their own ends.

Relief at this conclusion is the greater because, at several points during the hearings, there seemed to be some wonderment at the idea that honourable men can keep in watertight compartments information that they acquire in their different activities. Lord Kindersley put the point frankly, and it has been accepted in the tribunal's report:

> After many years now I have found that I can to my satisfaction divorce the knowledge which I know I have acquired from the Bank of England or one of the other companies, from my normal business judgment * * * I know that it is a difficult thing * * * and I have been in a very awkward situation many a time. If I can avoid discussion * * * I avoid it like the plague, but if I have got to discuss it I have found myself quite capable of doing that.

Yet the point remains. The position of a director of the Bank of England with other business interests—the very interests which qualify him to be a director—may occasionally be difficult and em-

* The Economist, Jan. 25, 1958.

barrassing. To surmount this, Lord Justice Parker even suggested, might call for "almost superhuman" qualities. Lord Kindersley, ten years a director of the Bank, admitted to ten or twelve occasions on which secret knowledge (not on Bank rate alone) might have been a source of embarrassment. And the report of the tribunal draws attention to the particular case of Mr. W. J. Keswick, to whom his colleagues in Hongkong looked for advice on Jardine Matheson's investments which he had a duty to give.

Is this burden unfair? Is it justified, so far as the Bank is concerned, by the benefit of advice and experience that could not be secured in any other way? The report does not express any view, for reasons that must be accepted as wise:

> This raises a general and very important question of policy with which we are clearly not concerned. Had it been our duty to express an opinion on this matter, we should, before doing so, have required exhaustive evidence as to the advantages and disadvantages of continuing a state of affairs which has so long existed. The criterion, of course, must be the national interest.

Many people, less wise, have jumped to the conclusion that there is no longer a proper role for the independent director of the Bank of England. This is, one may hope, a matter that will come within the purview of the Radcliffe Committee; certainly it is rooted in the fundamentals of monetary policy. Put quite shortly, it is one of the principal matters that will in future determine whether the Bank of England itself can continue to assert some effective degree of independent counsel and decision or whether it is to become merely a subordinate agent of Treasury policy.

It is possible to exaggerate both the embarrassment that may sometimes be caused to the outside directors of the Bank and also the direct use that is made of their counsel. The Governor of the Bank admitted that strain is occasionally put on directors from their possession of special knowledge, but in his twenty years' experience on the Court he had not found that it caused frequent difficulty to his colleagues; in any case of uncertainty, a director would consult him or the Deputy Governor about his proper course of action—as, indeed, Mr. W. J. Keswick did. Nor is this a problem exclusive to the Bank; it is an everyday occurrence throughout the range of banking and professional practice.

Nor, again, is it something new in the Bank's experience. Bagehot was deeply conscious of the point in the early seventies:

> But in fact the particular interest of single directors is not to be regarded; almost all directors who bring special information labour under a suspicion of interest; they can only have acquired that information in present business, and such business may very possibly be affected for good or evil by the policy of the Bank. But you must not on this account seal up the Bank hermetically against living information; you must make a fair body of directors upon the whole. (Lombard Street: Ch. VIII.)

Could the point be better put today? If the Bank is to be something more than "a mere operating department of the Treasury"—to quote a phrase used and rejected by the Governor—the quality of decision in the wide range of financial matters on which the Bank acts for or advises the Government (above all, perhaps, in the field of foreign exchange) must flow from precise judgment supported by the widest experience of financial, commercial and industrial life. In the last resort the Bank must conform, as any central bank must, to the sovereign power of government; but apart from the matters in which it exercises a direct responsibility, including the management of the money market and the fixing of Bank rate, there is a wide area in which the Bank, in consultation with and tendering advice to the Government, can, and should, make its influence felt in the formulation of economic policy.

The proximate responsibility in this does indeed fall on the Governor and Deputy Governor. They have the assistance of the four executive directors and the staff. Thus the permanent establishment of the Bank is the predominant force in its decision-making. The other directors are not originators of policy, but they are informed and consulted about major policy proposals. In the Governor's words:

> The directors of the Bank cover between them a very wide range of interests in banking, industry, commerce, trade unions, shipping and insurance. . . . It is quite invaluable to the Governors to be able to draw on this fund of knowledge and experience in formulating policy and to be able to share with the Court responsibility for decisions which must affect sterling throughout the world. . . . If the nature of the Court were to be altered so that it were not to be composed of active practical men of business, or if directors were to become mere figureheads divorced from the real affairs of the Bank, then it is my belief that the utility of the Bank to the public interest, in this country and in the Commonwealth, would disappear.

Good arguments would be needed to overthrow this conclusion—far better ones, indeed, than those that are now being used in favour of making the Bank subordinate without question to the Treasury.

Indeed, the weakness of the present system is not that the Bank still preserves some aspects of independence, but that in practice these are so vestigial. The independent director is the last remaining symbol of an independent Bank. Theoretically, the Court on a Thursday could refuse to endorse a change of Bank rate. Any such change would first have been set in motion by the Governors, agreed to in principle by the Chancellor of the Exchequer and accepted by the Committee of Treasury (acting, as it were, as a subcommittee of the Court) on the preceding day. But in theory the Court could upset it; hence the preparations by the Governor and the Deputy Governor to carry all the directors with them last September in a change critical in both size and timing. Yet, in retrospect, the weakness of a national power of veto unsupported by any positive opportunity for the directors to play an originating part in the formulation of policy emerges from the proceedings before the tribunal. It took six weeks from August 7th, when the Chancellor of the Exchequer left instructions for a study to be made in the Treasury of the possibility of "bringing about a measure of deflation in the economy" before action on public investment, bank advances and Bank rate was decided. Holidays got in the way; the monetary position continued to be "watched very closely"; consultations proceeded between the Bank and the Treasury in the pattern of a formal dance. It was not so important that a lot of people during these weeks came to know that action was afoot, as that, when the storm that had long been rumbling over sterling finally broke, umbrellas were still furled and had to be opened so desperately to shelter from it.

For the Bank, supported by its outside directors, to propose action that it had reason to apprehend might not be supported by the Government could be held to jeopardise the relations between the two.

But such differences have not been unknown; they are natural and it is a good thing that they should be aired from time to time. Perhaps there were differences during those six weeks—with the Bank unwilling to move unless the Government moved too. They do not emerge from the evidence, but when they occur they should be matters on which the Bank ought to feel that it has a duty to the public, and is accountable to it.

As the proceedings before the Parker Tribunal have shown, the public has a close interest in the way the Bank is constituted and served by its directors. But its respect for the Bank is less than it was, simply because the Bank's part in affairs is allowed to appear so negative and subservient. That is not nearly so true of central banks in other countries. It is within the power of the Bank of England to invest itself with greater authority. The Governor should feel more free to explain what the Bank's views are, and its annual report should be a document of substance. So the Bank could develop, not indeed as in any sense a rival power in economic policy-making, but as a more respected coadjutor and source of independent economic opinion. And it is here that the part of the independent director could be of decisive importance.

THE CITY UNDER THE GLASS

Some of the highlights on the City and its institutions in the 300 pages of proceedings and evidence before the Parker Tribunal are picked out below.

Bank Rate Timing

Never, presumably, will the mechanics of reaching a Bank rate decision be revealed so soon after the event or in such detail. The bare chronology gives its own impression of mounting crisis.

1957	
Aug. 7:	Chancellor orders study in the Treasury "to bring about a measure of deflation in the economy."
Aug. 8:	Sir Roger Makins (Joint Permanent Secretary of the Treasury) talks with Governor of the Bank of England at the Treasury.
Aug. 12:	Further talks at Bank of England.
Aug. 22:	Governor and Deputy Governor call at Treasury. Governor gives his views on desirability of rise in the Bank rate.
Aug. 26:	Meeting of Chancellor with Treasury officials to discuss proposed measures.
Aug. 28–29:	Deputy Governor tells Commitee of Treasury and Court of Bank of England that Bank rate has not come under discussion with Treasury, but is being kept under review.
Sept. 3:	Deputy Governor writes to Mr. W. J. Keswick and two other directors of the Bank out of London "and not expected back for the best part of a fortnight," informing them of discussions on measures to deal with the exchange situation, which might eventually include action on Bank rate, though that was "quite open and undecided." The letters were not to be taken as a warning that they might be recalled to London.
Sept. 4:	Deputy Governor tells Committee of Treasury that discussions are still proceeding. Sees Chancellor in the afternoon to discuss bank advances. Bank rate "just mentioned," but agreed that "the subject did not arise at that stage."
Sept. 6:	Sir Roger Makins talks with Deputy Governor regarding proposed measures "including a possible move in the Bank rate."
Sept. 9:	Meeting of Chancellor, Deputy Governor, Chairman and Deputy Chairman of Committee of London Clearing Banks to discuss restriction of bank advances.

Sept. 11: Committee of Treasury informed by Deputy Governor of discussions with Chancellor; the programme was "still undecided, but depending on how it went we might have to consider whether there was a part to be played by Bank rate." Deputy Governor discusses with Sir Roger Makins draft statement to be made following week by Chancellor, including no reference to Bank rate. Any recommendation by the Court would have to await return of the Governor (on holiday from Aug. 24 to Sept. 14).

Sept. 12: Court of the Bank of England informed on discussions. Continuation of talks on bank advances (see Sept. 9).

Sept. 13: Deputy Governor has "short discussion" with Chancellor on Bank rate; no figure mentioned. Sir Edmund Compton (3rd Secretary, Treasury) prepares paper on consequences of increased Bank rate at different levels.

Sept. 14: Governor returns from leave and spends 24 hours at Deputy Governor's house.

Sept. 15: Joined by Mr. Parsons, executive director of Bank for discussion on exchange questions. Meeting with Sir Roger Makins at 5.30 p. m. Join Chancellor and Economic Secretary at 6 p. m. Governor indicates "provisional view" in favour of increase in Bank rate to 7 per cent, and is asked by Chancellor to give the Bank's firm view by the evening of September 16th.

Sept. 16: Governor consults with available directors of the Bank on 2 per cent rise in Bank rate on September 19. Informs Chancellor at 6 p. m. (with Sir Roger Makins and Sir Leslie Rowan in attendance) that Bank considers such an increase desirable. Asked to give arguments for that view. At lunch Deputy Governor mentions to Mr. W. J. Keswick possibility of "swingeing" rise in interest rates.

Sept. 17: Arguments presented by Governor. Wording of statement on restriction of bank advances considered. At 9 p. m. Governor discusses with Chancellor his recommendation for 7 per cent Bank rate. Recommendation repeated to Prime Minister, who said "he would not make up his mind whether the Government should agree to the Bank rate being raised and, if so, to what figure, until following morning."

Sept. 18: 11.45 a. m. Sir Roger Makins informs Governor that Government would approve increase. 12.30 p. m. Governor and Deputy Governor recommend to Committee of Treasury (five regular members and two invited directors) for submission to Court on September 19 that Bank rate be raised from 5 per cent to 7 per cent. 4 p. m. Government Broker informed of increase by Chief Cashier.

Sept. 19: Proposal of Committee of Treasury approved by Court at 11.45 a. m.

DID THE JOBBERS SQUEAL?

Bagehot says in "Lombard Street" that "all 'City' people make their money by investments for which there are often good argumentative reasons; but they would hardly ever be able, if required before a Parliamentary Committee, to state those reasons." How did the stock market survive this test?

Evidence submitted by the Government broker, Mr. Mullins, throws some revealing light on the turnover in gilt-edged securities on September 18th. Almost £16½ million was bought by jobbers and £14 million sold—a balance of £2½ million bought by the market. In addition there seem to have been outright transactions between institutions selling and buying of a further £2 million. That, said the Government broker, was "by no means an abnormal day's turnover." Indeed, a week later turnover amounted to £62 million.

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He put the total sales to the market between 2.30 p. m. and the closing of jobbers' offices on September 18th at £4 million. After the Bank rate increase, there was a "considerable amount of talk about selling (on the afternoon of September 18th) by people who knew something." He agreed that jobbers are apt to take knocks, though "probably not of this magnitude"; at the same time the total of £2½ million taken on to jobbers' books did not strike him as a surprising amount at all. The Government broker, incidentally, makes it a rule never to deal on Thursday before Bank rate is announced.

The leading gilt-edged jobbers varied in their view of business that afternoon. Mr. Richard Holden, of Francis and Praed, felt that "people who dealt with us . . . knew something more than we did." His partner, Mr. Wilfred Barron, having mentioned that at lunchtime "we were all optimistic about the outlook for the market" (it had been firm since the beginning of the week) remarked later in the afternoon in the presence of financial journalists that "someone seems to know more than I do." His firm was then seeing a number of sellers and had no buyers and they had taken a loss.

CHAIRMAN. It is right to say that jobbers and the partners in your firm, which is a big firm, would not squeal lightly would they?—No.

You were all very annoyed?—We were annoyed, yes.

Allegations that the jobbers had squealed were clearly encouraged by a letter sent out on September 24th by Mr. Percy Spooner, senior partner in the jobbing firm of Wedd and Owen. They bought £165,-000 of stock from one firm of brokers and £20,000 from another after 3: 30 p. m. on September 18th and decided not to deal any more that day. Mr. Spooner was already contemplating the dismantling of his firm, and he admitted that in the letter he "used whatever occurred" as an excuse for doing something which he knew might become necessary in future in any case. The letter stated that the firm had for many years been prepared to deal after hours. "This facility," it said, "has occasionally been abused but never to the extent that it was on the night of Wednesday, September 18th last." But Mr. Spooner admitted that he was really taking advantage of these after-hours dealings to secure a necessary reduction in the firm's operations without affecting its credit.

On this part of the evidence, the outsider will conclude that not all jobbers in the gilt-edged market were prepared to grit their teeth and take a loss. They are not to be blamed for ceasing to trade if they think the scales are weighted against them; but the revelations in this section of the evidence demonstrate once again how far the erosion of jobbers' capital has gone, and the personal risks that they run, in these days of heavy taxation, in jobbing in the old commercial way. Even in gilt-edged stocks, the market is often thin to the point of disappearance, and the sudden reversal of the firmer trend of the previous two-and-a-half days as a result of a flow of after-hours selling was a legitimate point of concern to them. Yet the volume of after-hours offerings on September 18th might not have been impossible to accommodate if the stock had been offered during official hours. Nor would it have been likely to attract any attention if the daily turnover of the Stock Exchange was regularly published.

THROUGH LAZARDS' SWING DOORS

Rarely does the outsider have a sight of the working affairs of the merchant banks. Important aspects of the business of Lazard Bros. are revealed in the evidence.

Lazard Brothers conducts its day-to-day affairs through seven managing directors; there are also six other directors who attend monthly board meetings. The seven meet each morning, with Lord Kindersley *primus inter pares*, in informal discussion, and the activities of the house are threefold: acceptances, credits and money; new issue business; and stock business, including investment companies and clients' estates. Lord Kindersley and Mr J. V. O. Macartney-Filgate are responsible for the banking business; Mr P. Horsfall and Mr A. D. Marris are concerned with the industrial and new issue business; Mr T. H. Brand takes "an overall look" at the issue business and with Mr D. Meinertzhagen is responsible for the security business. "When we come to a decision in principle," Lord Kindersley stated, "it is up to *that* partner, *that* partner, or *that* partner to carry it out."

Lazards aim at keeping 50 per cent of call money and other available resources against the deposits placed with them by customers and "they take notice" if the ratio goes down to 40 per cent. Between mid-August and September 12th the ratio was slightly above 40 per cent; on September 19th it had been raised to 61.22 per cent.

On August 22nd deposits totalled £10,658,000 against almost £12 million on July 11th. From that date, there was a sharp drop of £2½ million to September 12th involving the sale of £1 million short-dated gilt-edged and the calling in of £500,000 loans to local authorities. On September 13th, the liquidity ratio against £8 million deposits was 40.72 per cent. If deposits had fallen to £7 million, Mr. Brand pointed out, a 50 percent ratio would have become the minimum for safety. On that day, there was "a common purpose," based on a suggestion by Lord Kindersley, to sell gilt-edged to meet the fall in deposits, though no decision to sell on that day (a Friday) or about the amount. The figure in his own mind to sell was £1,650,000; he was impressed for the need to "do it once and be sure of doing it adequately."

The matter was further discussed by Mr Macartney-Filgate, Mr Meinertzhagen and Mr Marris on September 16th (Mr Brand being away from the office); on September 17th Mr Brand approved the proposal of Mr. Meinertzhagen to sell up to £2 million; Lazards sold £1,450,000 on September 17th and 18th and retained holdings amounting to £3,700,000. After the increase in Bank rate, call money was deemed high, and £750,000 of gilt-edged was bought on September 23rd and 24th, reducing the liquidity ratio close to 50 per cent.

Acceptances of bills by Lazards totalled over £12 million. This figure, Mr. Macartney-Filgate stated, had a close bearing on the amount of call money that the house kept with the discount market. Lazards would have to pay the bills, whether their clients put them in funds or not; that fact necessitated the keeping of a certain amount of money on call for that purpose. The discount market, which had taken these bills, "have a pretty shrewd idea" of the total volume of the acceptances by any one name. They expect a certain amount of call money to be kept with them, and if it gets too low and remains too low "there might be some comment. Your prestige, your name might suffer.* * *" Against £12 million of acceptances, he would certainly not want to drop below £3 million in call money and would rather have more—particularly in periods of crisis—as a declaration of strength. The discount market would, of course, have no knowledge of the further strength of Lazards represented by its holdings of Treasury and bank bills and gilt-edged.

ROYAL EXCHANGE ASSURANCE

The Court of directors of the Royal Exchange Assurance meets at 12.30 each Wednesday; it concludes its business at 12.45 and the Treasury Committee meets thereafter. The proceedings in the Treasury Committee on September 18th were closely examined by the Tribunal.

The Investment Secretary of the Royal Exchange Assurance was the only witness to declare that Bank rate ought to have been raised at least a month earlier, to 6 per cent. He, like many others, had written off an increase as a possibility, though not devaluation. In this mind he was concerned with "a serious deterioration in the liquid position" of the Royal Exchange Assurance that had occurred in the three weeks to September 16th and he sought approval from the Treasury Committee on September 18th for sales of investments "to provide fully £500,000 after allowing for large pending departmental settlements and the interim dividend." In the event, stock was sold to realise £1,160,000 out of the REA's total holdings worth more than £20 million. These sales had been carried out by 3.30 p. m.

The commitments included the dividend (£270,000 payable November 6th), departmental settlements (£300,000) the corporation's potential liability under the Vickers issue (£400,000) instalments due on tanker loans (£150,000) a fire loss (involving £250,000 gross) and a bank overdraft (£230,000)—a total of £1,600,000. Many of these items, as the evidence showed, turned out to be considerable over-estimates, and provision appears to have been made already by the accountant for funds to meet the interim dividend. Nor, incidentally, does any allowance appears to have been made in the calculations for the effect of accruing premiums in alleviating a temporary state of illiquidity. It is commonly thought that insurance offices do not make large outright sales of investments (as distinct from switches). It was revealed that the Royal Exchange had in fact previously sold gilt-edged to the extent of £750,000 in January, 1956.

THE VICKERS UNDERWRITING

Attempts were made to postpone the Vickers' issues of loan stock and ordinary shares in the few days before September 19th.

Morgan, Grenfell and Co. underwrote the Vickers issues formally at 2.30 p. m. on September 16th. Offers of sub-underwriting were then posted and in the hands of the recipients on September 17th. Sub-underwriting was largely completed by 4.30 p. m. on September 18th when Lord Kindersley called on Lord Bicester, the senior director of Morgan, Grenfell, to discuss the effect of the issue on the market and the effect on City opinion of the issue being allowed to go forward when a severe increase in Bank rate must inevitably overtake it. The issue, it appears, had received Bank approval in August, and underwriting had been discussed informally and sub-underwriting commitments undertaken verbally a week before. The Royal Exchange Assurance underwrote £618,900 of the issues, including £400,000 of the shares, and Lazards underwrote £42,500 loan stock and £50,000 shares.

Lord Kindersley sought authority of the Governor of the Bank—having been told by him at 12:45 p. m. on September 16th of the intention to increase Bank rate—to discuss the Vickers issues with Lord Bicester. He satisfied himself on September 17th that by that time nothing could be done to arrest the issues. If the operation could have been postponed, the underwriters would have been released, but that could have been done only if the directors of Vickers had sought the approval of their shareholders. Meanwhile they were assured of their money. The underwriters stuck to their commitments, incurred considerable losses, and enhanced the reputation of the City by honouring their bargain. And fortunately the Vickers ordinary shares, though heavily "stuck" have not been too heavy a millstone on the rest of the market.

BUSINESS NOTES

BANKERS' SPEECHES—

The Bankers Pronounce

The statements of the chairmen of the big clearing banks have followed hard on each other this week, completing the annual round begun last week by Mr. Tuke of Barclays and Sir Harold Bibby of Martins. Their comments run as usual over a wide range, with one notable exception: Sir Oliver Franks of Lloyds Bank feels debarred by his membership of the Radcliffe Committee from commenting on domestic monetary developments; the loss is made good by a thoughtful survey of problems of sterling and international payments.

The bankers generally appear to approve the measures of September last, which have brought no profit to them; but they are emphatic that the need for these painful bludgeons has arisen from the Government's previous failings, particularly to cut its own expenditure. Lord Monckton, in his maiden speech as chairman of the Midland, points out that the failure of confidence overseas "sprang largely from a perhaps unduly sceptical assessment of the authorities' will and power" to apply corrective action. Sir Thomas Barlow, of the District, approves of the accent on the money supply—"costs and prices cannot spiral upwards without an increasing supply of money"—but Mr. Robarts, of the National Provincial, fears that the restriction of the money supply in the private sector both here and in the United States may lead to world recession, which by fostering Government expenditure would in the end lead to further inflation. All the chairmen indeed place great emphasis on government spending; and Lord Aldenham, of the Westminster, has the same objections as Mr. Tuke to financing the nationalised industries by borrowing rather than from their own or Exchequer revenue. The bankers' plans are in line with the demand by Mr. Cobbold last autumn that the budget should achieve a balance over all expenditures, below-line included.

The bankers feel, understandably, that the government's shortcomings in its own sphere have consistently placed an unfair burden on themselves, and on the private sector generally. Lord Monckton shows that whereas gross national income, in money terms, had risen by two-thirds between 1950 and 1957, credit balances on current accounts had actually fallen slightly.

And he gives a useful new measure of the increasing amount of work to which the stable volume of money has been put—"business turnover," comprising the annual totals of the turnover on current accounts at the Midland Bank, excluding the figures for a few City branches which are heavily affected by purely financial operations. The result shows a rise of 51 per cent between 1950 and 1957; Lord Monckton presumes that a similarly constructed index of all the clearing banks would not differ greatly. If the other banks should see their way to presenting such figures, an accurate measure of the velocity of deposits could at last be available.

Weak Spot of Bretton Woods

Nothing, Sir Oliver Franks points out in the searching analysis he presents to Lloyds Bank's shareholders, can change Britain's dependence on overseas trade; and in the past 5 years the sterling system has by no means worked to Britain's disadvantage. But it would be wise now to provide "appropriate financial arrangements and incentives" to the Commonwealth holders of the sterling balances to limit the stresses they place on the common system. Sir Oliver suggested that this might be done by maintaining here a combination of high long-term rates and (once the crisis is past) low short-term rates, to discourage the holding of balances in liquid form. This proposal would, of course, have major implications for domestic monetary policy.

Sir Oliver's main fear for the future is that the present system of world payments is ill-equipped to withstand the impact of general world deflationary influences, which may (and Sir Oliver puts it no stronger than that) be replacing the inflationary trends of the postwar years. If they do, the policies followed by creditor countries will be of decisive importance; and whereas there is always a sanction against excessive deficit, namely bankruptcy, the same is not true of excessive surpluses and "if over-expansionist policies can be suicidal, over-restrictive policies are undoubtedly fratricidal." The most serious weak spot of the Bretton Woods rule is that they provide no means of correcting (though they do provide a sanction against) the obstinate creditor.

CONTROL OF BORROWING AMENDMENT ORDER (1958)*

STATEMENT BY RT. HON. DERICK HEATHCOAT AMORY, M. P., ON THE CONTROL OF BORROWING

With permission, Mr. Speaker, I should like to make an announcement about the control of borrowing.

I want to repeat something which I said in this Chamber a fortnight ago in Committee on the Finance Bill. That is that the Government's economic objectives are fundamental and unchanging—to put the strength of sterling, the soundness of our international position, and price stability first.

I said at the same time that we would keep the policies by which we intend to reach these objectives flexible; and that we must in particular make sure that we go ahead as fast as conditions allow in those activities which concern our export trade and in industrial investment.

That was in relation to initial allowances. I consider that the time has come when, with the same objectives and without modifying these basic aims of policy, we can also safely make some limited relaxations in the control of borrowing.

As regards bank credit, I have decided that I need not ask the banks to restrict the total level of their advances to any given figure after the end of July. For the future I hope to dispense with official requests to restrict total advances and to retain control over bank credit by normal monetary measures reinforced by a new arrangement under which the Bank of England will, if need be, restrict the liquidity of the banking system by calling for special deposits. This will be a temporary arrangement pending the recommendations of the Radcliffe Committee, to whom we look for advice about any permanent changes. But it will be available if in the meantime existing monetary instruments are not sufficient to secure the necessary control over the credit system. These arrangements are recorded in more detail in correspondence between the Governor of the Bank of England and myself, which I will circulate in the Official Report.

In the second place I have decided to make adjustments in the scope of the Capital Issues control. They are set out in detail in a letter to the Chairman of the Capital Issues Committee, which will also be circulated in the Official Report. At the same time the Treasury has made an Order, published today and operating tomorrow, amending the Control of Borrowing Order.

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*The Statement of the Chancellor of the Exchequer, Rt. Hon. Derick Heathcoat Amory, and the exchange of letters between him and the Governor of the Bank of England, Mr. C. F. Cobbold, and the letter to the Chairman of the Capital Issues Committee, Lord Kennet, are reprinted in Hansard, "Parliamentary Debates, House of Commons Official Report," July 3, 1958.

Briefly summarised, the new provisions are these:

(1) The Committee may take a longer view in examining proposals which come before them; thus instead of limiting their consents to proposals which are currently urgent, they may assent to applications which anticipate future needs.

(2) In view of the new arrangements which I have just described for securing the necessary control of bank credit, the Capital Issues Committee will no longer be concerned with the appropriateness of bank finance for capital purposes;

(3) The exemption limit will be restored from the present level of £10,000 to the former level of £50,000.

(4) Bonus issues or capitalisation of reserves will no longer come before the Capital Issues Committee. But where the issue of redeemable securities is involved, the consent of the Treasury will be needed.

(5) The amending Order contains provisions to prevent the raising of new money outside the Control.

I need only add that we are determined not to return to inflationary conditions. But it is clearly right to encourage such sound development as we judge to be within our capacity. That is the main purpose of these measures.

LETTER FROM THE CHANCELLOR OF THE EXCHEQUER TO THE GOVERNOR OF THE BANK OF ENGLAND

1st July, 1958.

My Dear Governor: On 19th September last my predecessor stated that the situation required that the average level of bank advances during the coming 12 months should be held at the average level for the preceding 12 months. He informed the clearing bankers of this requirement, and they gave their assurance that, despite the difficulties, they would intensify the restriction of credit and do their best to achieve this result. Similar support was given by the British Bankers' Association and other banking associations and committees concerned.

In my Budget statement on 15th April I thanked the banks for the cooperation which they have shown in keeping down the level of advances fully in accordance with the undertakings which they gave to my predecessor; and I asked them to continue that policy.

After reviewing the development of the past few months, I have now concluded that the situation does not require that I should renew Mr. Thorneycroft's request in September and that some gradual relaxation between now and then is justified. I have therefore decided that I need not ask the banks to restrict the total level of bank advances to any given figure after the end of July.

At the same time, I trust that the banks, in framing their advances policy, will have regard to the revised guidance that I have given to the Capital Issues Committee in my letter of to-day (of which I enclose a copy) regarding the treatment of applications for which the consent of the Treasury is required. I should like to stress the importance which I attach in present circumstances to the provision of credit for export business, whether in the ordinary course of business or through medium-term financing under E. C. G. D. guarantee. I also wish to re-emphasize the hope which I expressed in my Budget Statement that projects for sound development in areas where unemployment is substantially above the average should not be held back by lack of credit or finance.

As to the future, it would clearly be wise to wait the recommendations of the Radcliffe Committee before considering any permanent changes in the methods of influencing the volume of bank lending. I regard it as essential, however, that in the interim period some provisional method should be at hand to reinforce the existing machinery of interest rates and open market operations if it should again prove necessary to restrain an increase of total bank advances. Both the Bank of England and the banking organisations have repeatedly impressed upon H. M. Government that the method of "official requests" made to the banks several times in recent years to restrict total advances, although it has proved efficacious for short periods, hampers the efficient working of the banking system and is thus damaging both to the banks and to the public interest if carried on for too long or too frequently renewed.

I accept this view and I should therefore be grateful if the Bank of England would between now and the end of July prepare an alternative scheme which could if necessary be introduced as a temporary measure pending the Radcliffe Committee's report.

I should be glad if you would inform the banking associations and committees concerned of the terms of this letter, and at the same time again convey to them the appreciation by H. M. Government of their ready and effective response to the requests made by my predecessors and myself in recent years.

Yours sincerely,

(Signed) DERICK HEATHCOAT AMORY.

C. F. COBBOLD, Esq.

LETTER OF 3RD JULY 1958 FROM THE GOVERNOR OF THE BANK OF ENGLAND TO THE CHANCELLOR OF THE EXCHEQUER

3RD JULY 1958.

DEAR MR. CHANCELLOR: I have informed the banking associations and committees concerned of the terms of your letter of the 1st July.

You ask that an alternative scheme should be prepared for use to reinforce the existing machinery of interest rates and open market operations if it should again prove necessary to restrain an increase of total bank advances. The Bank of England have now drawn up the heads of a scheme for "special deposits" which could be available for introduction as a temporary measure pending any recommendations which may be made by the Radcliffe Committee.

I have already discussed this scheme in general terms with representatives of the principal banking organisation concerned, and details are now being settled.

The broad outline of the scheme is as follows:—

When it appeared necessary, in support of other monetary measures, to restrict the liquidity of the banking system and thus the ability of the banks to extend credit, the Bank of England would call for special deposits to be made with them by the banks. Such deposits would carry interest based on the current Treasury Bill rate. They would not qualify for inclusion in the banks' liquid assets. There would be provision for partial release by agreement with the Bank of England when justified by special considerations.

The banks would continue to maintain their usual minimum ratios between liquid assets and total deposits.

Calls would be made on each group of banks separately, the amount being related to the total gross deposits of each group at a specified date with monthly adjustments to take account of variations in the deposits of each bank. The ratio of a call to total deposits would not necessarily be the same for each group.

Initially the scheme is being discussed with the Clearing and Scottish Banks, but it might later be more widely applied in the light of experience.

The scheme would serve to reinforce the existing monetary instruments and would be employed as a general control of credit in the same way and after the same sort of consideration as Bank Rate.

I understand that this scheme meets with your approval in principle.

I have conveyed to the banking organisations your renewed expression of the appreciation by H. M. Government of their co-operation.

Yours sincerely,

C. F. COBBOLD.

Rt. Hon. DERICK HEATHCOAT AMORY, M. P.

LETTER FROM THE CHANCELLOR OF THE EXCHEQUER TO THE CHAIRMAN OF THE CAPITAL ISSUES COMMITTEE

1ST JULY, 1958.

DEAR LORD KENNET: I have now completed my review of credit policy and the results as they affect the control of borrowing are set out in this letter for the guidance of yourself and your colleagues on the Capital Issues Committee. This letter is intended to supersede the memoranda and letters previously sent to the Committee.

PURPOSES

2. First as to the purposes for which consent should be given or withheld. Hitherto the basic guidance to the Committee has been the statement of principles in the letter written to you by Mr. Butler as Chancellor on 4th December, 1951. That guidance has since been modified from time to time by statements and requests which successive Chancellors have sent you on specific points reflecting developments in economic and financial policy. The practical effect of these successive statements and requests may be summarised as follows:

(i) The Committee are asked to recommend consent only when they are satisfied that the purpose of an application has definite urgency under current requirements;

(ii) In exercising their judgment on the merits of individual applications the Committee are asked—

(a) to recommend in favour of investment designed to maintain or increase the production of goods or services for essential purposes, with particular regard to the production of exports, the saving of imports and the earning of foreign exchange; and

(b) to recommend against investment for production or distribution or provision of services in the home market which in the judgment of the Committee can be postponed.

3. I have decided that this statement of the principles governing the work of the Committee should stand with one modification as regards the criterion of urgency. I now consider that the Committee can justifiably take a longer view and regard as eligible for consent an application for a purpose which may not be immediately urgent but which anticipates the future growth of requirements, bearing in mind that a primary objective is to stimulate production of exports, saving of imports and earning of foreign exchange. For the time being I do not consider that the criterion of immediate urgency should be relaxed where one of those elements is not present.

4. The Committee are asked to continue the practice of referring applications to the Government Departments concerned with the purposes for which the finance is required. The Committee will no doubt take full account of any advice, favourable or unfavourable, that may be offered by Departments. But I emphasise that the Committee are not bound by such advice and that I shall continue to rely on their personal judgment of the merits of each case that is referred to them.

5. The Committee should also continue the practice—where they think it appropriate—of discriminating between the several parts of an application and where they think fit recommending consent to the raising of finance only for part of a project.

SPECIAL OBJECTS

6. I do not suggest any general change in the list of special purposes which the Committee has hitherto been asked either to discourage or to encourage. But some modification of emphasis is required, and I think it will be useful to re-state these items as follows:

Speculation

Recommendations for consent for borrowing intended to finance the speculative buying or holding of shares, materials or real property (including the development of land) should continue to be withheld.

Investment trusts

The Committee may feel free to recommend consent to applications from investment trusts and unit trusts, but when considering cases in which the finance is proposed to be applied in making significant purchases of foreign securities, the Committee are asked to bear in mind that the principal benefit which these trusts bring to the economy is that they encourage savings and supply risk-bearing capital for British industry.

Hire purchase finance

Such applications should be critically scrutinised but the Treasury will be prepared to act on a recommendation in favour of an issue where the Committee considers that the raising of finance is desirable as a means of improving the stability of the hire purchase financial system.

Commonwealth projects

The Committee are asked to continue to give sympathetic consideration to projects which appear to them to be likely to contribute materially to strengthening the Sterling Area's balance of payments with the non-sterling world.

Investment in areas of persistent unemployment in Great Britain or Northern Ireland

Consent may be recommended to any proposal for sound development which is likely to reduce unemployment in an area of Great Britain where there is a high rate of unemployment which would otherwise be likely to persist, or to any proposal for financing investment in Northern Ireland which though desirable might not qualify for consent if the investment were made elsewhere in the United Kingdom.

BANK ADVANCES FOR CAPITAL PURPOSES

7. The time has come for the banks to resume full responsibility for the terms of bank advances. Applications for bank finance for capital purposes, being outside the normal course of the applicant's business, require Treasury consent under the Control of Borrowing Order and therefore will continue to be referred to the Capital Issues Committee for their advice. The Committee in dealing with such cases should consider the purpose of the proposals on the same principles as they apply to proposals financed from non-bank sources, but they should leave the appropriateness of bank finance and the terms as to period and repayment of advances to the discretion of the banks themselves.

CONTROL OF BORROWING ORDER

8. In addition to revising the policy guidance I have also revised the statutory framework within which the Committee operates, and the Control of Borrowing Order is being amended in the following respects:

9. First, the exemption limit. Since March, 1956, it has been unlawful to raise more than $10,000 in Great Britain without the consent of the Treasury. I have now restored the exemption limit to $50,000.

10. Secondly, the control over bonus issues or the capitalisation of reserves. The amending Order provides for the exemption from control of all capitalisation issues except for capitalisation of reserves involving the issue of redeemable securities. This limited class of issues will continue to require the consent of the Treasury, who will decide them without reference to the Capital Issues Committee since the purpose of retaining control over such issues is to prevent operations designed to reduce tax liabilities.

11. Finally, the Order has been amended to prevent new money from being raised outside the control by artificial devices. The object of the Capital Issues Control is to regulate the raising of new money: and following this principle, in April, 1955, the Treasury amended the Order to exempt from control certain classes of capital operations which for the most part did not involve raising new money, in order to free normal commercial transactions from restrictions. Unfortunately this relaxation has been abused and the exempt operations have been adapted to raise large sums of new money for undertakings which have been refused or would have been refused permission to borrow. As long as the control of borrowing is retained, it must be made effective, and I see no alternative but to restore statutory control over the classes of transactions that were exempted three years ago. I regret the inconvenience to legitimate business transactions. But I know I can rely on the Capital Issues Committee to recommend consent to such transactions with the minimum of enquiry and delay, and to concentrate their critical attention on the transactions that are really devices for raising new money.

12. In conclusion may I say to you and your colleagues how greatly I value your services and how glad I am that I can continue to rely upon your judgment and experience.

Yours sincerely,

(Signed) DERICK HEATHCOAT AMORY.

Rt. Hon. LORD KENNET, P.C., G.B.E., D.S.O., D.S.C.

DEBATE, HOUSE OF LORDS, JULY 22, 1958*

4:12 p. m.

Lord GRANTCHESTER rose to move. That an Humble Address be presented to Her Majesty praying that the Control of Borrowing (Amendment) Order, 1958 (S. I. 1958 No. 1097), dated 2nd July, 1958, laid before the House on 3rd July, 1958, be annulled. The noble Lord said: My Lords, I apologise for the formidable form in which this motion is worded. It is, I understand, the only way in which the important issues raised by this Order and the background against which it is set can be debated. I must also apologise in advance for the very technical provisions to which I shall have to refer. But, having made these apologies, I have no hesitation in saying that I am sure your Lordships would wish to consider and examine this new Order most carefully.

Together with the directives which have been given, the expressed intention is to secure the general control of credit. I would ask your Lordships to note carefully the words that are contained in a letter from the Governor of the Bank of England to the Chancellor of the Exchequer dated July 3. There he says this:

> The scheme will serve to reinforce the existing monetary instruments and would be employed as a general control of credit.

It is, of course, a general control of credit in the private sector, only, as the Chancellor of the Exchequer made clear in answer to a Question which was put to him when he announced this Order in another place. It is significant, I think, that at this time the Government should consider it necessary to bring in more and tighter controls. This, I suppose, is an admission that all is not yet well on the inflation front. This may well be so. But I shall seek to show that this is not the way to hold inflation at bay. Strange as it may seem to some who do not remember the days when there was freedom, there are still some of us who believe that controls create evils rather than cure them, because they prevent the automatic checks of the market from operating.

My Lords, this Order is made under the authority conferred upon the Treasury by the Borrowing (Control and Guarantees) Act, 1946. That was one of the restrictive measures introduced by the Labour Government immediately after the war. I am sure that even the Labour Government intended the provisions of that Act to be temporary, and I think they must be surprised at the use which a Conservative Government is making of it after some twelve years. Let us examine for a moment what sort of measure is this Act of 1946. Briefly, it gave the Treasury power to control the borrowing of money in excess of £10,000. By an Order under the Act the figure of £10,000 was increased in 1947, by the Labour Government, to £50,000. The Act also controlled the raising of money by the issue of shares or

*Extract from Hansard, "Parliamentary Debates, House of Lords, Official Report," July 22, 1958.

debentures. The Labour Government clearly expressed their purpose when they passed this Act, in a White Paper which they issued at the same time in which these words appear:

> The planning of the investment programme as a whole must be continually guarded by the Government.

These sentiments of "planning the investment programme as a whole" accord with Socialist thinking on this matter.

My first question to the noble Marquess who is to reply is, are these also the sentiments of the present Government? If so, I am surprised. If not, I would ask, why do they play with the poisoned barbs of Socialism? In practice, applications under this Act for consent to borrow are made to the Treasury who give or refuse permission to borrow without giving any reasons, on the advice of a body which is known as the Capital Issues Committee. I ask your Lordships to note that this is control without any reasons being given for refusal, and without any appeal if a citizen is refused permission to borrow. I would ask why the excellent decision to require reasons to be given, taken by Her Majesty's Government in considering the Tribunals and Inquiries Bill which is now before honourable Members in another place, cannot be adopted here? Why should that rule not be applied to the Capital Issues Committee? So I would put as my second question to the noble Marquess: if you intend to keep the Capital Issues Committee in being, is it not wrong to allow it to continue to exercise control without any reasons being given for refusing application and without any right of appeal from its decisions?

I think no one will dispute that the decisions of the Capital Issues Committee have been quite unpredictable—that is putting it in polite language, which is not always current in the City when the decisions of the Capital Issues Committee are discussed. May I give one or two examples of the unpredictability of its decisions? On an application on behalf of a company called Worthington-Simpson, in December, 1956, consent was refused for the issue on capitalisation of reserves of one share for two. A year later, or rather less, permission was given for an issue of one share for one. In the meantime there had been no alteration in the directives in force. A similar result followed two applications made within eight months by Great Universal Stores. Instances such as these do not inspire confidence. There was a great deal of speculation about the reasons for the decision of the Capital Issues Committee in the case of Rhodesian Anglo-American. If there was a reason behind that decision, why be so modest as to keep it in the dark? Our leading financial newspaper has commented upon the eccentricities of the Capital Issues Committee, and has gone so far as to say that there is apparently no limit to them.

Before I leave the 1946 Act, from which the current Order springs, I must refer to the Schedule which contains the provisions as to enforcement and penalties. The Schedule provides that:

> Any person who contravenes any provision of any order made under this Act—

and I ask your Lordships to take particular notice of those words, so the new order is included, shall be liable (here I am abbreviating to save time) to heavy fines and imprisonment up to two years or to both imprisonment and fine.

But that is not the worst of this Act. It is not the kind of Act we in this country like. Paragraph 4 of the Schedule, which I think can properly be called iniquitous, provides that in the case of an offence committed by any company, any person who is a director, general manager or secretary or any other officer, or anyone who was purporting to act in any such capacity, shall be deemed to be guilty of the offense unless he proves, in short, that he is innocent. That is not the kind of Statute we like to have on the Statute Book in this country. I hope the noble Marquess will not proudly assert the intention of Her Majesty's Government to uphold the rule of law and at the same time allow this Statute to remain unrepealed. A man is innocent, as we in this country like to think, until he is proved to be guilty. So I would ask that neither the noble Marquess nor his right honorable friend in another place will rest content until this offensive provision is removed from the law of this land.

In March last Mr. Butler gave to a Conservative meeting an undertaking that it was the intention of the Government to remove, during the lifetime of the present Parliament, all the remaining economic controls. I certainly should have expected this measure to be one of those which he would wish to remove. I shall reinforce this plea when I come to consider the language of the new Order. But with all these fearsome threats of heavy fines and imprisonment, I must admit that sometimes the opportunity is taken to introduce a little comedy. There was the case where, presumably on the advice of the Capital Issues Committee, the Treasury sanctioned the borrowing by a hopeful applicant of some £4 million. One day someone may tell the full story of that curious episode. If, after studying the file, the noble Marquess still wishes to defend this system which is being imposed upon us, I shall be surprised. The approval which was given for the borrowing of some £4 million held good until two months ago. I wonder how many applications were turned down while this credit was open in order to keep the authorisations to be allowed during the period within the limit fixed by the Treasury? I think that aspect is a serious one. I referred to this case as a comedy, but it is not really comical at all. This kind of fiddling with the economy brings the Treasury into disrepute and makes the institutions of the City look foolish and ridiculous.

I want to say a few words about the new Order, and first about the manner in which it was introduced by the Chancellor of the Exchequer. It was represented by him as a liberalising measure. The Chancellor of the Exchequer remarked [Official Report, Commons, vol. 590 (No. 134), col. 1599]:

We can safely . . . make some limited relaxations in the control of borrowing.

That was the emphasis placed upon the Order by the Chancellor when he introduced it. He probably had in mind the small retail trader and the individual who sometimes requires temporary accommodation at the bank and who, unlike some of the bigger companies, has been unable to arrange alternative facilities during the time this control has been on. The door of the bank manager's office may be open again to the small retail trader and the private individual—I hope so—but I fear their confidence has been rather badly shaken by the last interference by Her Majesty's Government, as between banker and customer, which I believe is a very bad thing.

I should like further to test how far this Order is the liberalising measure it was represented to be. I do not want to take up your Lordships' time by too detailed examination of the Order. It will perhaps be sufficient if I summarise the effect of the amendments which have been brought in by this Government Order. There are twelve amendments to four articles. One restores the right to borrow up to £50,000 without consent, which, as I have already said, was the limit from 1947 until 1958. There is no special reason to be proud of, or to take credit for, a reversion to a limit which was fixed by a Labour Government in 1947. One amendment permits the capitalisation of reserves by the issue of shares which are not redeemable. I shall have to refer again a little later to the question of redeemable shares. All the other amendments are designed to tighten control—not relax it. So I ask whether the emphasis in the statement made in another place by the Chancellor of the Exchequer was not wrongly placed upon relaxation.

I will return just for a minute, if I may, to the limitations imposed upon the issue of redeemable shares. Surely this is an unwarranted restriction. If the Treasury believes that in certain cases the issue of such shares is a matter which involves tax considerations, then surely that should be dealt with in a Finance Act and not under an Order of this kind. This is the first time, at any rate in an Order, that control has been introduced for taxation reasons and not for economic reasons.

I would ask those of your Lordships who are interested in official phraseology to look at paragraph 8, at the top of page 3 of this new Order. I think that anyone who does so will agree that it is quite beyond the comprehension of the ordinary businessman. And this, my Lords, is one of the provisions by which, if contravened by him, he will go to prison, being deemed guilty unless he proves himself innocent! I hope that I have said sufficient, in drawing attention to the provisions of this Order, to show that on balance it should be more correctly described as a retrograde step in restriction rather than as a relaxation of control

Before concluding, I should like to make three brief comments upon the directives which have been issued in conjunction with this Order. First, there is the provision for special deposits. What may be the effect in practice of releasing the banks from the requirement that they should keep their advances within an overall figure, while at the same time holding over them this new threat, only experience will tell. If the banks put themselves in a position to increase their advances the Bank of England can immobilise their cash resources by requiring them to deposit part of those resources with the Bank of England. In principle I think it is necessary to register the strongest objection to a power of this kind, the exercise of which is quite unpredictable. At least the banks knew where they were when they were restricted to an overall figure; but there is no indication of any rule by which this new idea of special deposits will be exercised.

It seems to me, that this goes back to that White Paper of the Labour Government in 1946. Her Majesty's Government are really trying to get—is it a general control of investment? Is that what they are after? Is one of the results of this Order likely to be a greater demand for Government securities in the market? If that is the intention behind it, or even if it is not the intention but if that proves to be the result, I say that it will strike a further blow at confidence in the gilt-edged market, which has been so badly shaken by the attempts of a former Government artificially to influence rates of interest.

The second matter in the directives to which I would refer is the favour shown to unit trusts, which is limited. They can have a little more money but they must not invest it in any substantial amount in foreign securities. As purchases of dollar securities have to be made in the dollar pool, it seems to me that the reason for this restriction is not quite obvious. Perhaps the noble Marquess can explain the purpose of that limitation.

The other matter upon which I should like to seek some clarification is the emphasis all through these directives upon the undesirability of lending for speculative purposes. The suggestion is that borrowing is not to be permitted for the purchase of materials—I will not refer to stocks and shares, but it is not to be permitted for the purchase of materials or for the development of land. I should very much like to know what is meant by the use of the words "speculative purposes" in these directives. As I understand it, all production or buying in anticipation of demand is speculative, the exception being production under contract. I do not know what is meant by this emphasis upon "speculative purposes." I do not know what interpretation will be placed upon it for those who deal in the commodity markets, but it seems to me that it may at times deprive our manufacturers of opportunities to buy raw materials when prices are considered advantageous and that this could be detrimental to our export trade.

Then I come to the restriction on the development of land, and the question I want to ask the noble Marquess is: Has the idea of a property-owning democracy been abandoned? The directive is being interpreted in some quarters as banning the lending of money, even "bridging" finance, for the building of houses for sale. If a small builder came along and wanted finance to help him build a dozen houses, in the days before the war that was called speculative building, because he had not sold the houses before he built them. Is the interpretation to which I have referred the intention of this directive? Perhaps the noble Marquess will make the position of Her Majesty's Government clear on this matter, because it is very important, particularly in the provision of houses by the development of land. In some quarters speculation is associated with making a profit. I wonder whether that is what the drafter of this paragraph had in mind. That might as least make some sense in some quarters. But how misleading and dangerous all this is! Abandon the test of profitability and you will bring down the market economy and destroy both the standard of living and the welfare services which have been built up out of private profit. I suggest that the time has come when Her Majesty's Government should abandon new and better attempts to indulge in more effective intervention. Surely they need not in this way anticipate the coming to power of a Socialist Government, but should be showing us a better way.

My Lords, what is this better way, and what does it involve? We would reply that it involves allowing the market to do the controlling—that is, the people who have the savings to invest. I should not use the word "controlling" at all. I would say: "Let the people who have the savings to invest do the choosing." It also means, I think, that the

Government should allow the nationalised industries to submit their case to the discipline of the market: that they should secure the money required for the expansion of the nationalised industries out of savings, in exactly the same way as any other industry has to secure money for expansion.

There are, however, measures which Her Majesty's Government should take if the credit position is not to get out of hand: but this is not controlling the private citizen in his borrowing—it is restraining the actions of the Government themselves. I suggest, as I have said on a number of occasions before, that they must put a limit to the currency issue, which has been going up and up all the time; and they must refrain from increasing the number of Treasury Bills by which they pay for their overspending. This Order, which seeks to cure the symptoms of the malaise from which this country has been suffering, is in itself a confession of failure on the part of the Government to restrain the overspending or which they are responsible, for to enable them to continue that overspending they have had to create credit—and they are the only people who can create credit. That has led to the most dishonest of all results—the debasement of our currency.

My Lords, I suggest that we must bestir ourselves with this new Order before us. We must sound the alarm again. The danger to which the Government were aroused a year ago is not yet past, as this Order proves—otherwise, we should not have it. That danger will not be surmounted until the facilities which the Government have to expand credit to meet their own overspending are limited. The Government must not be allowed to evade the issue. They must not be allowed to pretend that the control of the citizen is the remedy, when the root of the trouble in the economy lies in their own failure. I beg to move.

Moved, That an Humble Address be presented to Her Majesty praying that the Control of Borrowing (Amendment) Order, 1958 (S. I. 1958 No. 1097), dated 2nd July, 1958, laid before the House on 3rd July, 1958, be annulled.—(*Lord Grantchester.*)

4.44 p. m.

Lord TEVIOT: My Lords, we have listened to a very forceful speech from the noble Lord, Lord Grantchester. There is just one question I should like to ask in regard to this Order. In paragraph 4 of the Schedule to the Act of 1946 there is what I consider to be a most objectionable method of dealing with directors, general managers, secretaries, and anybody connected with any business. I should like my noble friend who is to reply to say, if he can, whether this is embodied in the Order which we are now asked to consider. I will not trouble the House by reading out the passage, because it is rather lengthy; but it is a terrible threat to anybody who is a director of any company or connected with any business. I was not aware of it until this moment. But it makes me shake in my shoes, to think that, without my knowledge, certain things may happen to businesses of which I am a director, or that I may suddenly find myself under the punishment suggested in this Schedule to the Act of 1946. I hope that my noble friend will be able to say that that has been eliminated in this new Order. That is all I wish to say on the subject, but it is something I feel sure all of us would like to see removed.

4.46 p. m.

Lord PETHICK-LAWENCE: My Lords, we have listened to a most erudite speech from the noble Lord, Lord Grantchester, who has moved this Prayer, and I think that anyone who attempted, without the great knowledge which he evidently has, to deal with this subject without expert advice would be a very brave and a very bold man. I certainly do not claim the knowledge that would enable me to deal in detail with any of the questions which the noble Lord has so skilfully raised. I cannot say that I envy the noble Marquess who has to reply, because it seems to me that if he were to attempt to reply adequately to all the remarks made by the noble Lord, Lord Grantchester, we should be here well into the hours of the night. However, there are just one or two points that I should like to make.

I am quite sure your Lordships will not be surprised when I say that I am not rising in order to support the Prayer which the noble Lord wishes us to raise. Equally, I am not here to defend in detail all the minute clauses and sub-clauses of this order, and I propose to address myself to one or two wider considerations. The noble Lord speaking from the Benches of the Liberal Party has put forward what I gather is the attitude of his Party to the financial control of this country. We are glad to have that, because we are rather accustomed to a great deal of criticism from the Liberal Party, both of the actions of the present Government and of the various proposals of the Labour Party, and we always want to know what the Liberal Party would actually do themselves.

The noble Lord who has moved this Prayer told us what his own attitude, at any rate, was, and I think we are entitled to gather that it is what the attitude of his Party would be. As I understand it, his object would be to remove all controls and to let everyone go his own way, and to hope that out of that chaos a really good Government of this country and a good economic position would evolve. But I am not quite sure whether, in fact, he really would go as far as that, because there is one control which I believe (he will correct me if I am wrong) he would wish to maintain, and that is the control of the bank rate. But so long as that remains the final sanction of the economics of this country it is idle, futile and incorrect to consider that the Liberal Party really desire to remove all financial control from persons in this country; because (I have said in this House before, and I shall say it again) the most deadly control, the most potent control, and the control which has the greatest power to work evil, is the control of the bank rate, improperly used. Therefore, when the noble Lord comes to this House and says that his Party stand for having no controls, I do not believe that that is really correct.

I maintain that the controls in these Orders, in principle, are less injurious than the blind, "bludgeon" control which is involved in the indiscriminate use of the bank rate. Though I would not eliminate the right to use the bank rate, because in certain circumstances that might be absolutely essential, I have always maintained that this blind force should be mitigated by some selective control—though it will interfere, as all control must do with the liberty of the individual—such as has been found from time to time in these Orders. The Party opposite, who believe in the principle of a "free-for-all" economy, have found it necessary to keep on some of these Orders, most of which existed during the war and some of which were retained by the Labour Government. On the other hand, we on this side do not claim that we stand for a "free-for-all" economy; but we do not wish to have any control which we do not think is required by the necessities of the time. So much for the principle.

There are a great many points in the noble Lord's speech which need a considerable amount of thought. No doubt we shall be having a financial debate on the Second Reading of the Finance Bill next Tuesday, and some of the points with which he has dealt I shall hope to deal with in the course of that debate. I would only say now that I think that we are much safer with some of these deliberately created selective controls than with one single control of the bank rate which, even if it be necessary, can, and always does, cause great hardship to individuals and work great havoc with the economy as a whole. There is one point, however, which the noble Lord made, which I should like in some way to support, and I would ask the noble Marquess who is going to reply to give his attention to this.

On March 25 of this year, arising on a Question put by the noble Lord, Lord Conesford, and answered by the noble Earl, Lord Selkirk, we had an exchange of views on the Capital Issues Committee, upon which the noble Lord, Lord Grantchester, has spoken. It was pointed out [Official Report, vol. 208 (No. 49), col. 390] that:

> A White Paper was published in May, 1945, giving the broad principles on which the Committee would give its advice to the Chancellor of the Exchequer.

The Committee referred to was, of course, the Capital Issues Committee. I would just remind your Lordships that May, 1945, was a time when not the Labour Government but either the Coalition or the Caretaker Government were in office and Sir Winston Churchill was Prime Minister. The noble Earl, Lord Selkirk, added:

> These principles have been changed from time to time to meet current economic requirements and the terms of letters to the Chairman have been published in Answers to Questions in Parliament.

Then there were some further cross-remarks, and my noble friend Lord Wilmot of Selmeston said this:

> My Lords, would it not be wise, in view of the length of time that has elapsed since the publication of the White Paper and the numerous modifications which have been made by way of correspondence, to publish a new White Paper giving those principles as they are now?

The noble Earl replied:—

> My Lords, I will certainly see that my right honourable friend bears that point in mind, which I think has a certain force.

I would ask the noble Marquess whether he shares that view of his noble friend and thinks that there is some force in the point that was put forward by my noble friend, that a statement, not detailed but of the general principles which guide the Capital Issues Committee, might with advantage be given publicity. With that one exception, I am afraid that I disagree almost in toto with the noble Lord, Lord Grantchester. I hope that the noble Marquess will give your Lordships as much information as he can, but I hope that he will not keep us until eleven or twelve o'clock, because I think that by that time we shall be getting rather tired.

4.58 p. m.

The Marquess of LANSDOWNE: My Lords, I think your Lordships will all appreciate that this is certainly not the terrain which I would have selected on which to attempt to act as an interpreter of the law for the noble and learned Lord, Lord Grantchester. For him, with his experience of the City, of banking and of the law, the course which he has been pursuing this afternoon has been along old familiar paths. I must confess that for me, until very recently, much of the country traversed by the noble Lord was in a large measure terra incognita. The noble Lord was good enough to let me know last night of the general line of the argument which he would develop to-day and also to enumerate some of the specific points upon which he would call for clarification. I have done my best to study the somewhat recondite and complicated points and I am most grateful for the intervention of the noble Lord, Lord Pethick-Lawrence, who has warned me of how complicated they are, but I shall do my best to deal at least with some of them.

With your Lordship's permission, I will first turn to the specific points and then in rather more general terms give your Lordships the point of view of Her Majesty's Government in support of the Control of Borrowing (Amendment) Order, which is, I must remind your Lordships, the subject of the noble Lord's Prayer this afternoon. With great respect, I think that his extremely interesting speech ranged somewhat beyond the limits one might perhaps impose in the terms of this Motion. The noble Lord referred to the increasing complexity of this branch of legislation, and on that point at least I am in complete agreement with him. The 1958 Amending Order which we are discussing to-day is, in fact, the fourth instrument amending the original Control of Borrowing Order of 1947, and it has now reached such a state of complexity that it is extremely difficult to discover the current state of the law.

It is no secret that we have received a number of complaints from City solicitors and others on this score. But when changes are made it is desirable that they should take the form of Amendments to the existing law, so that everybody concerned can see at once just what has been done. In time, however, these super-imposed piles of amendments tend to form an almost impenetrable mass of deletions and additions. Your Lordships will, I feel sure, be pleased to know that it is intended to make a Consolidated Order in the very near future which will set out the existing law in one single and intelligible instrument.

The noble Lord, Lord Grantchester, referred to certain other specific points, and to the best of my ability I will attempt at least to clarify those points and try to put the view of the Government. He referred to the original White Paper of January, 1946. The purpose of that White Paper was shortly this: that it was the policy of His Majesty's Government of that day to keep the balance between the economic resources of the community and the demands made upon those resources. As the noble Lord said, it was further stated therein:

> That the planning of the investment programme must be continuously guided by the Government.

It stated also:

> That the Capital Issues Committee would be continued and that an investment council would be set up to assist the Government in organising investment to promote full employment.

It is still the policy of Her Majesty's Government to keep the balance between the economic resources of the community and the demands made upon those resources, and it is for this reason that the C. I. C. is being retained in existence.

The noble Lord also referred to the Borrowing Control Guarantees Act, 1946. Under that Act two things were done. The Act enabled the Treasury to make orders controlling borrowing as strictly defined by the Act, or the raising of money by issues of shares. It also enabled the Treasury to make loans for the development of industries or parts of industries. The Schedule contains particulars of the penalties to which the noble Lord, Lord Grantchester, has referred with such horror, including fines up to £500 or three months' imprisonment or both, which may be incurred by contravening any order made under that Act. Here I think is where some explanation is required. That Act was certainly intended as a permanent piece of economic legislation to enable the Government to deal with either booms or slumps. The purpose of having the power to make orders is that flexible policy can be pursued which accords with changing economic conditions. It is not the policy of the present Government to favour detailed control—there are other detailed methods for controlling investment—but we have kept the monetary control, as the noble Lord, Lord Pethick-Lawrence said, through the bank rate and through restriction on bank advances, and also the selective control through the Capital Issues Committee to which the noble Lord referred.

The noble Lord, Lord Grantchester, then spoke, I thought with some vehemence, about the manner in which decisions were taken and the method used by the Capital Issues Committee. The practice of the C. I. C. is perfectly simple and is as follows. Applicants reply to a detailed questionnaire designed to elicit from them all the material facts, and if more information is then needed the staff of the Capital Issues Committee make further inquiries from the applicant. A summary of each application is then prepared which sets out all the relevant facts. This is sent to all the members of the Committee a few days before the weekly meeting at which the Committee decides on its recommendations, and in reaching its decision in each case the Committee has regard to the principles laid down by the Chancellor of the Exchequer.

Perhaps it would be convenient if I here refer to the question put to me by the noble Lord, Lord Pethick-Lawrence, arising out of the discussion we had in your Lordships' House on March 25. The noble Lord call the attention of your Lordships to the reply made by my noble friend Lord Selkirk. In fact what was suggested by the noble Lord, Lord Wilmot of Selmeston, has taken place, for the letter written by the Chancellor of the Exchequer to the Chairman of the Capital Issues Committee amounts to being the new White Paper. It was written on July 1; it was alluded to on July 3 and it was published in the *Hansard* of that day. That directive has been published and is available for everyone to see. Therefore I think the question raised by the noble Lord, Lord Wilmot of Selmeston, has been answered, and we are in possession of a perfectly up-to-date White Paper which gives in complete detail what the directive of the Chancellor of the Exchequer is.

Lord LATHAM: May I ask whether all previous directives were annulled by the recent one?

The Marquess of LANSDOWNE: I do not want to weary your Lordships by going into too much detail, although I am in possession of the facts, but, broadly speaking, the answer to that question is that it supersedes everything that went before.

The noble Lord, Lord Grantchester, referred to certain specific cases. As noble Lords will be aware, it would be quite improper for me to disclose the reasons for or against approval given by the C. I. C. One of the regulations is that the cases of the applicants are not disclosed, and this, as the noble Lord will realise, is certainly in the interests of the applicants themselves. I could, perhaps, suggest reasons in general terms. Certainly in the case of Mr. Roth there is an explanation which I think it is proper to make. It is not the duty of the Treasury or the C. I. C. to decide on the substance of the individual himself who makes the application. What they have to decide on is what the application is for. It is certainly not the function of the Treasury or the C. I. C. to go into what I might call the credentials of particular applicants.

I think, if I understood him aright, the noble Lord, Lord Grantchester, suggested that by allowing some £4 million and more to be raised by Mr. Roth, perhaps other people were kept out of the queue. This, I must explain at once, is a misconception, because there is no limit to the amount that may be raised, and, therefore, the fact that this particular gentleman was able to raise that sum of money had no effect on the general picture whatsoever. I hope that answers that question satisfactorily.

There is also a point which perhaps the noble Lord would care to bear in mind, and that is that one of the directives given which may perhaps have a certain bearing on cases he has considered, was that the Committee were asked to see that bonus issues were made only as a single operation in the capitalisation of true reserves. I do not want to have to go into that in detail, but I am sure the noble Lord will appreciate that it may have some bearing in certain cases which he has laid before us this afternoon.

Lord LATHAM: Does that exclude reserves from a revaluation of capital assets?

The Marquess of LANSDOWNE: That is rather difficult; I should like to have notice of that question. A reference was made to special deposits. In fact—and I hope the noble Lord will not object to my saying this—that is quite irrelevant to the subject of his Motion. But perhaps I might say this in passing. As the noble Lord knows, on July 1 the Chancellor of the Exchequer wrote to the Governor of the Bank of England announcing his decision to remove the limit on bank advances which Mr. Thorneycroft had asked the banks to observe, and asking the Governor to prepare an alternative scheme for restraining any increase in total advances. The letters referring to that are again public, and were published in Hansard on July 3, 1958. The technique for operating this scheme is still under discussion, so there is nothing that can be added at the present time to these letters.

I have tried, I am afraid perhaps not altogether successfully, to deal at least with some of the points that have been raised in the extremely interesting and learned speech of the noble Lord, Lord Grantchester, and I think I have replied to the one question put to me by the noble Lord, Lord Pethick-Lawrence. As to the question asked me by my noble friend, Lord Teviot, I am afraid I must explain to him that, interesting though this question is, it does not apply to the Order under discussion. It applies to the Act of 1946, and so is not relevant to this Motion. As it is an extremely difficult and complicated question, I suggest that the noble Lord should ask it another time.

Lord GRANTCHESTER: My Lords, I do not want to interrupt the noble Marquess, but surely that is not so. The Act governs all the orders that are made under it, and so it governs the present Order.

The Marquess of LANSDOWNE: With all respect to the noble Lord, it is very presumptuous of me to argue with him on a matter of this sort, but I understood his Motion was a Prayer for the annulment of a specific Order.

Lord GRANTCHESTER: It is an Order made under the Act of 1946. That is the authority for making it and, surely, the penal provisions of the Act of 1946 expressly provide that those penalties apply to any Order which is issued under the Act. I do not want to press the noble Marquess, but perhaps he will look into it.

The Marquess of LANSDOWNE: I shall be pleased to look into the matter further, but I still maintain that what the noble Lord is really asking for is the annulment of the Act of 1946, whereas the Motion he has put down is for the annulment of the Order of 1958.

I have dealt to the best of my ability with a number of the points that have been raised, and I should like now to put before your Lordships the case against this Motion. Your Lordships will have seen that this Order, in fact, does three things. First, it raises to £50,000 the limit of the value of transactions which are exempt from control, and thus restores the position which was in force from 1947 until March, 1956, when the limit, as your Lordships know, was reduced to £10,000. In the view of the Government, the economic situation now justifies this cautious relaxation of some of the credit restrictions and the resumption of some measures to encourage investment.

Secondly, this Order exempts from control most issues made to capitalise profits or reserves, which are commonly called bonus issues. As your Lordships will appreciate, no new money is raised by the issue of bonus shares and no wealth is brought either to a company or to its shareholders. The purpose of such an issue is usually only to bring the capital structure of the company more into line with its real assets. A company is thus able to present a more realistic balance sheet. But it is still necessary to keep the control over bonus issues of redeemable securities, because some of these issues are designed to reduce tax liabilities. Nevertheless, it would not have been right simply to prohibit bonus issues of redeemable shares. In some cases these issues are used, as your Lordships will know, as a convenient method by which shareholders of family companies can ensure that cash is available to pay estate duty due on the death of a substantial shareholder, and so avoid the need to sell vote-carrying shares and the risk of allowing the control of the company to pass out of the hands of the family. The Order therefore provides that issues of redeemable bonus shares should not be prohibited but should require Treasury consent—I say deliberately. "Treasury consent", because it is taken outside the ambit of the powers of the Capital Issues Committee.

The third effect of this Order is to bring some classes of transactions under control. Most of these transactions are those which were exempted by the amending Order made in April, 1955, which was designed to let out transactions, such as those between associated companies, by which no new money was raised. But by a combination of transactions, each in itself exempt from control, companies have found three main ways of raising capital: by carrying out operations which have the same effect as if property were charged by way of mortgage; by acquiring in return for the issue of shares the shares or the undertaking or the assets of another company whose assets consist largely of cash or of securities that can readily be sold for cash; and by borrowing money temporarily without security and then converting such borrowings into permanent capital by the issue of shares in satisfaction of the indebtedness. Each of these operations will once again require consent.

The Order, however, still leaves a wide range of normal transactions exempt from control, of which some of the most important are: borrowing from a bank in the ordinary course of the borrower's business; borrowing temporarily—and I emphasise the word "temporarily"—without security; issuing shares as consideration for the acquisition of property on the incorporation of a private company; issuing shares for conversion or redemption of existing issues. I hope that your Lordships will see from this brief outline that the general effect of this Order is to make two modest relaxations in the control of credits while at the same time preventing the main evasions of the control, and this with as little interference as possible in normal commercial operations.

I feel sure that it will have been appreciated by your Lordships that although this Motion has served a valuable purpose in enabling these matters to be debated, if it were to be passed we should not be proceeding to a happy state of perfect freedom; we should only be returning to the more onerous but also relatively less effective restrictions that were in force up to three weeks ago. That would be the effect of annulling this present Order. In these circumstances, I most sincerely hope that the noble Lord, Lord Grantchester, will not wish to press his Motion.

5:22 p.m.

Lord GRANTCHESTER: My Lords, I think the patience of the House has already been sorely tried so I will not say more than a few words. I should like to thank the noble Lord, Lord Pethick-Lawrence, for his intervention and to say how honoured I am that he should have intervened in the manner he did. If I may reply to the question that he raised, speaking for myself I do not believe that bank rate should be regulated by the Chancellor of the Exchequer. I think bank rate is a reflection of conditions in the money market and should be fixed by the monetary authorities. That is my personal view, but I will not argue that now.

I should like to thank the noble Marquess for the gallant and courteous way in which he has grappled with this very complicated matter. I gather from what he said that he excludes from speculative purposes any transaction which is in the ordinary course of business, whether the money is borrowed temporarily from the bank or whether it is borrowed as a "bridging" operation for the building of houses by a building society or an insurance company. If so, I think that ought to be made clear. The only objection I have to the remarks made by the noble Marquess was when he questioned the inclusion of the directives in my comments. I look upon these as part of the Order, because they are really intended to interpret the Order. That was why I thought I was entitled to refer to the directives in discussing the Order. I did not expect that he would be able to say that Her Majesty's Government would at once repeal the Act of 1946 and all the Orders that go with it; but I did expect that he might say at least that they would give second thoughts to this matter. That is what I hope they will do. After all, quite simply, all I am asking is that the Government should practise in their legislation the principles that they profess. I recognise their preoccupation at the moment with more important matters in the international field, but I hope that the noble Marquess will consult with his right honourable friends as soon as convenient to ensure that this matter is not overlooked for action.

There are a great number of supporters of Her Majesty's Government who have great experience—greater than I have—on this subject in the City, and I ask whether it is not significant that no one has come here this afternoon to defend this Order. The waste of time and of ability, the sense of frustration engendered by these procedures, is notorious. Having ventilated this matter, I think time should be given to Her Majesty's Government to have second thoughts. If they do not, I should like to have your Lordships' permission to raise the matter again. At the moment all I can do is to ask your Lordships' leave to withdraw the Motion.

Motion, by leave, withdrawn.

INCOME TAXATION IN THE UNITED KINGDOM*

The Income Tax Act (ch. 10) of 1952 consolidated the provisions contained in the Income Tax Act, 1918, and some 50 subsequent acts. This consolidation, together with the income tax sections found in the Finance Acts of 1952 to 1958, inclusive, constitutes the existing statutory provisions under which income tax is imposed on individuals, partnerships, companies, and other taxpayers.

PERSONAL INCOME TAXATION

The United Kingdom income tax is in general chargeable on the total income received from all sources by individuals resident in the United Kingdom. However, individuals domiciled abroad who acquire United Kingdom residence to perform services for an oversea employer are subject to United Kingdom income tax only on that portion of their income remitted to the United Kingdom. Consequently, management and technical employees domiciled in the United States who enter into a contract with U.S. parent companies to take up residence in the United Kingdom to operate their British branches or subsidiaries and who stipulate that their salaries or a portion thereof be deposited to their U.S. bank account are liable to United Kingdom tax only on that portion withdrawn or remitted to the United Kingdom.

Individuals not resident in the United Kingdom are normally subject to United Kingdom income tax on all income derived from sources in the United Kingdom. However, this principle is substantially modified for U.S. residents by the exemptions granted by the United States-United Kingdom Income Tax Convention, to which reference is made later in this report.

Allowances

An individual with earned income may deduct from his gross income £890 or two-ninths of the first £4,005 of income, whichever is less, plus £660 or one-ninth of the next £5,940, whichever is less. Consequently, the maximum allowance is £1,550 on an earned income of £9,945 or over. "Earned income" consists principally of income from a profession, employment, pensions, and from business carried on alone or in partnership.

Personal allowances include: £140 for a single person; £240 for a married man; and £100 for each child not over 11 years of age, £125 for each child over 11 but not over 16, and £150 for each child over 16. If the earned income of his wife is included in the taxpayer's total income he may also deduct £140 or seven-ninths of the wife's earned income, whichever is less. There are also special allowances for persons 65 years of age or over, for dependent relatives, and for life insurance premiums.

*Excerpt from U.S. Department of Commerce, Bureau of Foreign Commerce, World Trade Information Service, pt. 1, Nos. 58–68 (September 1958).

Standard income tax rate

Since the year of assessment beginning on April 6, 1955, the first £60 of taxable income has been subject to tax at the rate of 2 shillings (s.) 3 pence (d.) in the pound (11.25 percent); the next £150, at 4s. 9d. in the pound (23.75 percent); the next £150, at 6s. 9d. (33.75 percent); and the remainder, at the standard rate of 8s. 6d. in the pound (42.5 percent).

Surtax rates

The surtax applies to individuals only and is not levied on companies. Income which has been subject to deduction of the standard rate of tax at source (dividends, interest, patent royalties, etc.) is included with other income for surtax purposes. The surtax is always assessed direct against the individual recipient of the income. The taxpayer is not required to make a separate return as the assessments are usually made from the return submitted by the taxpayer for standard income tax purposes.

Surtax payments are in effect deferred tax assessments; for example, surtax assessed for the year 1956–57 was payable on January 1, 1958, instead of January 1, 1957, when the standard income tax fell due.

The surtax had prior to 1956–57 applied to that part of the total income (without deduction of personal allowances and earned income exemption granted for the standard tax) in excess of £2,000. However, the Finance Act of 1957 provided that the amount by which the personal allowances exceed the single person's allowance may be deducted from total income in computing the income chargeable to surtax. The allowances taken into account for this purpose are the single allowance, the marriage allowance, the child allowance, the dependent relative allowance, and the housekeeper allowance. Since the married allowance of £240 exceeds the single-person allowance of £140 by £100, a married couple will have a surtax exemption of £2,100. From the year 1957–58, the surtax for which will be payable on January 1, 1959, the new child allowances varying with the children's ages will also be deductible.

The surtax rates are as follows, in percent:

	Percent		Percent
1st £2,000	0	Next:	
Next:		£2, 000	32. 5
£500	10. 0	£2, 000	37. 5
£500	12. 5	£2, 000	42. 5
£1, 000	17. 5	£3, 000	47. 5
£1, 000	22. 5	Remainder	50. 0
£1, 000	27. 5		

Taxes on specimen incomes

The amounts of income tax and surtax, if any, for specimen incomes where the income is either all "earned" or all "investment" in origin are shown in table 1.

TABLE 1.—*Income tax (and surtax, if any) on earned and investment income, 1958–59*

[In pounds (£) and shillings (s.)]

Income (pounds)	Single person		Married couple without children		Married couple with 2 children not over 11		Married couple with 2 children over 16	
	Earned income							
	£	s.	£	s.	£	s.	£	s.
500	55	10	27	17	—	—	—	—
1,000	211	1	168	11	85	10	51	15
2,000	541	12	499	2	414	2	371	12
2,500	756	17	704	7	599	7	546	17
5,000	2,092	15	2,027	15	1,897	15	1,832	15
10,000	5,659	5	5,579	5	5,419	5	5,339	5
20,000	14,684	5	14,591	15	14,406	15	14,314	5
50,000	42,434	5	42,341	15	42,156	15	42,064	5
100,000	88,684	5	88,591	15	88,406	15	88,315	5
	Invested income							
	£	s.	£	s.	£	s.	£	s.
500	93	0	59	5	6	15	—	—
1,000	305	10	263	0	178	0	135	10
2,000	730	10	688	0	603	0	560	10
2,500	993	0	940	10	835	10	783	10
5,000	2,518	0	2,453	0	2,323	0	2,258	0
10,000	6,318	0	6,238	0	6,078	0	5,098	0
20,000	15,343	0	15,250	10	15,045	10	14,953	0
50,000	43,093	0	43,000	10	42,795	10	42,703	0
100,000	83,343	0	89,250	10	89,045	10	88,953	0

The method of calculating the income tax and surtax payable by a married man, with two children over 16 years of age, having an earned income of £5,000 in tax year 1958–59, is as follows:

	£	s.
Income	5,000	0
Less earned income relief: 2/9 of £4,005 (£890), and 1/9 of next £995 (£110 11s.)	1,000	11
Remainder	3,999	9
Less personal allowances as married man, £240; 2 children over 16, £300	540	0
Taxable income	3,459	9

The income tax on £3,459 9s. is calculated as follows:

	£	s.	d.
£60 at 2s, 3d. (11.25 percent)	6	15	0
£150 at 4s. 9d. (23.75 percent)	35	12	6
£150 at 6s. 9d. (33.75 percent)	50	12	6
£3,099 9s. at 8s. 6d. (42.5 percent)	1,317	5	3
Income tax	1,410	5	3

In addition, the amount subject to surtax is calculated as follows:

Total income	£5,000
Less surtax exemption, £2,000; personal allowance as married man, £100; 2 children, £300	2,400
Subject to surtax	2,600

The surtax on £2,600 is calculated as follows:

	£	s.
£500 at 2s. (10 percent)	50	0
£500 at 2s. 6d. (12.5 percent)	62	10
£1,000 at 3s. 6d. (17.5 percent)	175	0
£600 at 4s. 6d. (22.5 percent)	135	0
Surtax	422	10

Thus, a married man, with two children over 16 years of age, earning £5,000 will pay an income tax of £1,410 5s. 3d. and a surtax of £422 10s., or a total of £1,832.15s. 3d.

Capital gains

The United Kingdom has no capital gains tax. However, capital profits may be assessable for income tax and surtax if they arise from a transaction which is in the nature of trade. Whether a given transaction is taxable is often uncertain.

Transactions in property carried out by established businesses seldom give rise to any difficulty; if the property concerned is of the type normally dealt in by the business the proceeds of its sale are clearly income rather than capital. However, the determination of whether an isolated purchase and sale of property, or sporadic purchases and sales, produce taxable income or nontaxable capital profit is more difficult and has often given rise to litigation. Each case is decided on its own facts and it is not possible to set forth criteria which will be determinative in all cases. Some of the relevant considerations to which the tax appeal commissioners and the courts have looked are the subject matter of the transaction, the length of the period of ownership, the effort made to effect the sale, the circumstances that were responsible for the decision to sell, and the purpose of the transaction of purchase and sale.

By express statutory provision any profit derived from the sale of a patent is taxable. The net capital sum from the sale of a patent is taxed one-sixth in the year of sale and one-sixth in each of the 5 succeeding years unless the vendor elects to have the entire proceeds taxed in the year of sale. A loss resulting from the sale, disposition, destruction, or disappearance of a capital asset is not deductible.

TAXES ON CORPORATE INCOME

The taxable profits of a company (an incorporated business) operating in the United Kingdom are subject to income tax at the standard rate and to a profits tax on distributed and undistributed earnings. An excess profits levy on companies which had been in effect from January 1, 1952, was abolished as of January 1, 1954.

Income tax

After a company (an incorporated business) operating in the United Kingdom is taxed at the standard rate (since April 6, 1955, 42.5 percent) on its total taxable profits, no further tax at the standard rate is payable to the British Government by either the shareholders or the company on a distribution of such profits, but, on payment, the company is entitled to deduct the appropriate tax from the dividends.

The tax "appropriate" to a dividend payment is the standard rate of tax for the year in which the dividend was declared, regardless of the rate at which the amount distributed was actually taxed when the company was assessed on its profits. The company thus more or less recoups itself by deducting the standard rate of tax, which it retains, so that the company may be considered as ultimately bearing the tax only on its undistributed income.

The shareholder receiving the dividend is regarded in the British income tax regulations as having paid by deduction the tax appropriate to the dividend. The standard rate of tax being collected at the source, it sometimes happens that recipients of small incomes—especially those deriving the major part of their income from share and other investments—are exempt from tax, or more tax has been collected (through deductions at source) than is actually due because of personal allowances of the recipient, in which case on the filing of a claim a refund is made. However, where the company declares no dividend, the shareholders have no direct concern in the payment by the company of the tax on its profits.

Companies, on issuing dividend warrants or checks, are required to have annexed thereto a statement showing the gross amount, the rate and amount of income tax appropriate thereto, and the net amount actually paid. Companies may declare a gross dividend from which the tax is deducted certifying that the dividend is paid "less income tax," or declare a dividend certified as "free of tax" but indicating the amount of tax appropriate thereto to show a computed gross dividend. While such dividends in the hands of the shareholder are not subject to any further income tax at the standard rate, the surtax of the individual is calculated on his total income from all sources, including his gross dividends.

Profits tax

The profits tax was originally known as the national defense contribution, which was introduced by the Finance Act of 1937. Its present title derives from the Finance Act of 1946. The principles of this tax are therefore established by the act of 1937 as modified by subsequent finance acts.

Under the provisions of the Finance Act of 1958 the profits tax, from which individuals and partnerships are exempt, will, effective from April 1, 1958, be levied on companies at a single rate of 10 percent, so that the combined income and profits taxes on companies will be 52.5 percent on total income.

From April 1, 1956, to March 31, 1958, the profits tax had been imposed at the rate of 30 percent on distributed profits, but undistributed profits were granted a relief of 27 percent so that profits added to reserves or otherwise reinvested in the business bore a rate of 3 percent. The total taxes payable on company profits then varied according to the proportion of profits distributed, with the effective combined income and profits taxes ranging from a minimum of 45.5 percent where there was no distribution to a maximum of approximately 62.9 percent on total distribution.

However, where a British company was controlled by a nonresident company through holding not less than one-half of the voting power in the British company, distributions made to the nonresident company were left out of account in arriving at the British company's net distribution subject to the higher rate. Therefore, in the case of a British subsidiary wholly owned by a U.S. parent company, its total tax on profits was 45.5 percent, i.e., 42.5 percent income tax and 3 percent profits tax.

Effective from April 1, 1958, the profits tax rate of 10 percent will apply uniformly to the total profits of all companies. There are special and very technical transitional provisions dealing with the allocation to chargeable periods of dividends paid after April 1, 1958.

The taxable profits, subject to minor adjustments, are determined on the same principles as profits arising from a trade or business are computed for income tax purposes. The profits tax is not an allowable deduction for computing profits for income tax calculations.

Relief is granted to small-business enterprises by exempting from tax one-fifth of the amount by which profits fall below £12,000. This has the effect of providing full exemption for profits of £2,000 or less. [Revised paragraph.]

Capital expenditure allowances

In the postwar period the income tax law has provided special allowances for certain capital expenditures to encourage the reequipment and modernization of British industry either in the form of initial depreciation (accelerated) allowances or investment (supplemental) allowances. Since the application of each of these allowances has been wholly or partially suspended from time to time, a review of the chronological developments may be helpful in understanding the current situation.

Initial depreciation allowances.—A system of initial allowances for capital expenditures on plant and machinery, on the construction of industrial buildings, and on mining works was introduced in 1945, but it was suspended as of April 6, 1952.

A year later initial allowances were reinstated for expenditures made after April 14, 1953. These initial allowances applied on the same basis to the profits tax and the income tax and could be taken in the year in which the investment was made. The rate for plant and machinery was fixed at 20 percent and that for capital expenditures on the construction of industrial buildings at 10 percent. The rate of initial allowance for capital expenditures, both at home and overseas, on new mining works (a term that includes such things as pits, shafts, and oilwells but not plant and machinery) was set at 40 percent instead of the 10 percent granted in the 1945–52 period.

These initial allowances in effect result in accelerated depreciation writeoffs or, from another viewpoint, are essentially similar to interest-free loans. The initial allowance merely anticipates a part of the annual allowances so that the tax liability is less in the year in which investment takes place, but may be larger later on.

Investment allowances.—In his budget speech of April 6, 1954, the Chancellor of the Exchequer stated:

> I have tried to devise some fresh encouragement to put money into productive investment. This is the more essential since the physical and financial resources at our disposal are now sufficient to allow a substantially higher rate of investment than we are undertaking * * *. After considerable reflection, therefore, I have decided to take a further step, and replace, subject to a few exceptions, the present initial allowances by a new system which I call investment allowances (Hansard, Apr. 6, 1954, col. 224).

The investment allowance gave a tax-free allowance equal to a part of the cost of investment made after April 6, 1954, in assets qualifying for it, and applied for the purposes of both the profits tax and the income tax. It was given additional to the full annual depreciation allowances. The rates of investment allowance were 20 percent for expenditure on new plant and machinery, scientific research, and mining works and 10 percent for new industrial and agricultural buildings. For example, 20 percent of the cost of new machinery could be deducted in the first year, and then the normal depreciation allowance could also be taken (i.e., 100 percent spread over the life of the machinery) so that eventually 120 percent of the cost would have been allowed in deductions.

Expenditures on agricultural buildings and on plants and buildings used for scientific research were not eligible for initial allowances, but they were eligible for the investment allowance. On the other hand, this tax-free benefit was not available either for secondhand plant and machinery which did not represent new investment or for ordinary motorcars which can and often do serve both business and private purposes, but these assets will continue to rank for the initial allowance at 20 percent.

Current provisions.—The Chancellor announced on February 17, 1956, that as a general rule no investment allowances would be given for capital expenditures becoming due and payable after that date but that such expenditure would in the future qualify for the rate of initial allowance in force in 1953. (See above.) It was stated that there would be two classes of exceptions. First, where a definite contract had been placed by February 17, 1956, for the purchase or construction of capital assets the investment allowance would still be given in respect of such expenditures when they became payable. Second, the Chancellor indicated that in a few special cases expenditure would continue to qualify for the investment allowance, and that the necessary legislative provisions would be presented later in the finance bill. In the parliamentary debates on this change it was emphasized that the investment allowances were suspended—rather than abolished—for the purpose of slowing down somewhat the current tempo of new investment, and the position of initial and investment allowances might be reconsidered each year.

The Finance Act of 1956 made three exceptions to the general suspension of the investment allowances. An investment allowance of 20 percent remained in effect for expenditures for the construction of ships, for scientific research (construction of buildings or works or the provision of new machinery), and for prescribed fuel-saving equipment installed by way of replacement or modification in existing industrial premises. However, the Chancellor in his budget speech of April 9, 1957, proposed that the investment allowance in respect of expenditure incurred after that date on the construction of ships should be at the rate of 40 percent instead of 20 percent. Fuel-saving plant eligible for the 20-percent investment allowance includes mechanical firing equipment for solid fuel, oil-firing equipment, back-pressure engines and turbines, waste-heat-recovery equipment, feed-water-treatment plant, and control equipment.

From February 17, 1956, to April 14, 1958, initial depreciation allowances were at the rate of 10 percent for industrial buildings and

20 percent for plant and machinery. The Finance Act of 1958 provides that, effective from April 15, 1958, the initial depreciation allowance for industrial buildings will be 15 percent and for plant and machinery, 30 percent.

Overseas trade corporations

The Finance Act of 1957 provides special income and profits tax treatment for companies whose profits arise wholly outside the United Kingdom. The broad effect of these provisions is that a company managed and controlled in the United Kingdom but operating wholly overseas will not be liable to United Kingdom tax on its trading profits unless or until these are distributed. The scheme came into force from the beginning of the income tax year 1957–58, i.e., on April 6, 1957. To be eligible for this tax relief a company must qualify as an overseas trade corporation (OTC).

Qualification requirements.—To qualify as an OTC a company must be resident in the United Kingdom and must either (1) carry on a trade outside the United Kingdom, or (2) be a company which does not carry on any trade, either in the United Kingdom or outside, but which is the principal company of a subsidiary company which is an OTC.

The business must be conducted outside the United Kingdom. Thus, an OTC may sell to a purchaser in the United Kingdom but may not maintain a marketing organization there. However, where the business of the company is the production of a commodity of a kind bought and sold by agents and brokers in a recognized market in the United Kingdom, e.g., cocoa, coffee, copper, cotton, rubber, tea, or tin, an exception is allowed and the company may sell in the United Kingdom through an agent or broker.

A company which buys goods for export from the United Kingdom for the purpose of marketing them abroad may qualify for OTC status. The OTC may not take delivery of such goods in the United Kingdom except on board the ship or aircraft in which they are exported and all charges incidental to delivery on board must be borne by the seller. The company, as purchaser, may neither provide services in respect of the goods while they are in the United Kingdom, nor, apart from the purchase price, incur charges for insuring, preserving, warehousing, transporting, or otherwise dealing with the goods while they are in the United Kingdom.

To achieve OTC status a company must be trading abroad in such a way that the whole of its trading profits are taxable there or, if it is in a tax-free area, would be so taxed if a tax similar to income tax existed. In effect, this means that the profits of an OTC must arise from trading *within* an oversea country (for example through an office or permanent establishment) and not merely from trade *with* an oversea country.

Specifically excluded from OTC status are banks, businesses engaged in lending money or providing capital or credit facilities for consumer installment buying, securities firms, insurance companies, and the business of shipping or air transport or chartering ships or aircraft. Also excluded is any business whose receipts consist of payments which are either for the professional services of individuals ordinarily resident in the United Kingdom or for the copyright of any literary, dramatic, musical, or artistic work by an author who is

32061 O—59——25

ordinarily resident in the United Kingdom. A company may not qualify as an OTC if it is carrying on a trade in the Republic of Ireland.

Whether or not a company qualifies as an OTC is determined annually by the Inland Revenue. A company which has once qualified as an OTC may apply for a direction that it shall not qualify as from the beginning of any tax year; however, in certain cases the tax authorities may refuse to grant the request and continue to treat the company as an OTC for tax purposes.

Tax treatment of OTC's.—The benefit to a company qualifying as an OTC is that no United Kingdom income or profits tax is payable on its oversea trading income so long as that income remains undistributed. Moreover, funds accumulated out of trading income can be switched between related OTC's without incurring liability for United Kingdom tax. The exemption is limited to "trading income," which is defined as income arising from any trade carried on by an OTC, including dividends, grants, and loans received from a related OTC insofar as paid out of trading income. "Investment income," which is income derived from securities or other investments together with any other income not derived from trading, is liable to income tax in the normal way.

For any year in which a company is classed as an OTC, its trading income and its investment income, if any, must be calculated separately; losses in one may not be set off against the other. If earnings are used to pay dividends or make grants, loans, or payments in connection with a capitalization of profits, such a distribution is deemed to have been paid out of trading and investment income in the ratio which these classes of income bear to total income for the period to which the distribution relates. For that part paid out of investment income, normal tax procedures apply, i.e., the tax deducted is retained by the company as a setoff against tax levied on investment income. For that part paid out of exempt trading income, tax is assessed on the company which must be paid 1 month after assessment, instead of on the usual January 1 due date; the company may, however, deduct and retain income tax at the standard rate from the distribution to shareholders.

In assessing income tax on distributions, credit is given for any oversea tax incurred. If, for example, an OTC pays tax in the country where it trades at the rate of 2s. in the pound, it will pay United Kingdom tax at the rate of 6s. 6d. in the pound, that is, the standard rate (8s. 6d.) less double-taxation relief.

Trading income is exempt form the United Kingdom profits tax. Investment income is subject to profits tax in the normal way, that is, at 10 percent.

Companies managed and controlled in the United Kingdom which do not qualify for OTC status pay income and profits tax on total profits wherever these arise and irrespective of whether any profits earned abroad are brought to the United Kingdom or are retained abroad for reinvestment there. Many British companies conduct their oversea activities through subsidiary companies controlled and managed outside the United Kingdom. However, profits in the form of dividends which the British parent company receives from one foreign subsidiary cannot be switched to other foreign subsidiaries without becoming subject to United Kingdom tax.

Statutory provisions governing OTC's are contained in the Finance Act of 1957 in part IV (secs. 23 to 27) and schedules 4 to 8. Certain detailed matters are dealt with in regulations issued by the Commissioners of Inland Revenue and published as the Income Tax and Profits Tax (Overseas Trade Corporation) Regulations, 1958 (Statutory Instruments No. 392/1958). An explanation of the main features of the law and practice relating to OTC's is contained in a booklet entitled "Overseas Trade Corporations—Explanatory Notes," issued by the Board of Inland Revenue.

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THE ECONOMIC IMPLICATIONS OF FULL EMPLOYMENT*

Presented by the Prime Minister to Parliament
by Command of Her Majesty
March 1956

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THE ECONOMIC IMPLICATIONS OF FULL EMPLOYMENT

I.—Introduction

1. The White Paper on Employment Policy (Cmd. 6527), issued by the Coalition Government in May 1944, set out the policies to be pursued after the war to maintain a high and stable level of employment and to combine this with a rising standard of living. These policies have been applied with considerable success. Full employment has, in fact, been maintained in most parts of the country over practically the whole of the past ten years, and we are to-day consuming more as a nation than we have ever done before. But full employment has brought with it one problem to which we have not yet found a satisfactory solution: yet, unless we do find the solution, it will be more difficult to achieve a further advance in living standards, and full employment itself may be threatened. The problem is that of continually rising prices. It affects everyone, and everyone must contribute if it is to be solved. The purpose of this White Paper is first to focus attention on it, analysing its causes and explaining its dangers, and then to suggest what will have to be done by the Government and people of this country if reasonable price stability is in future to be maintained.

II.—Full Employment since 1945

2. In the years immediately before the war the average rate of unemployment in the United Kingdom was over 10 per cent. Since the war it has never (except for a few weeks in 1947) exceeded 3 per cent. For most of the period 1945–1955 it has been under 2 per cent.; and it is now about 1 per cent. These figures are for the country as a whole. Unemployment in Northern Ireland and some other areas has remained appreciably above the national average, but has been much lower than before the war.

3. The maintenance of full employment has been accompanied by a rapid increase in production. Since 1946 the national output of goods and services has risen by 30 per cent.; industrial production alone has risen by 56 per cent. But only part of this increase has been available for improving living standards, because there were other, more urgent, claims on our resources to be met. We have had to devote our efforts to making good the physical damage and destruction of the war, to overtaking the arrears of capital investment, and to restoring our overseas earnings, which had been seriously run down during the war. Moreover, we need much larger exports than before the war, partly because import prices have risen more than export prices, and partly because we have lost a large proportion of our pre-war income from overseas investments. These difficulties had been only partially overcome when, in 1950, the outbreak of war in Korea and the growing international tension compelled us to undertake a substantial programme of rearmament. In the past two or three years, however, the individual consumer has become the main direct beneficiary of the increase in production.

4. If we take full advantage of the opportunities open to us, there is every prospect that we shall be able to secure a further big improvement in our living standards in the years ahead. We are on the eve of great technical advances in the application of nuclear energy and electronics to industrial processes. Under the stimulus of full employment new attitudes to production are developing on both sides of industry and increasing attention is being paid to raising standards of technical training and education. The possibilities of economic progress and the importance of productivity command a greater understanding and a wider degree of acceptance than they did ten years ago. As new techniques of production are developed, more efficient methods of work are introduced, and the

benefits of rising investment are felt, we can look forward with confidence to a continuing expansion of our capacity to produce; and this rising productive capacity will provide the means for a further progressive improvement of our standard of living. It is right that we should look forward to this possibility: the ultimate objective of economic expansion is to satisfy the natural desire of mankind to enjoy a fuller life, in terms of security and happiness, leisure, and the fulfilment of personal hopes and ambitions. But a sustained growth of the economy is no less essential to enable us to discharge our duties as a major political and industrial Power, to sustain our commitments in many parts of the world, and to contribute to economic development overseas.

5. The future growth of production in this country must, of course, be affected by what happens in other parts of the world. A nation which is as dependent as the United Kingdom on overseas trade could not hope to maintain the full momentum of economic expansion in the face of a severe or prolonged recession in the rest of the world. But all member countries of the United Nations are committed, under the United Nations Charter, to mantain full employment; and in the past decade the majority of the industrial countries have succeeded in doing so. A growing recognition of the truth that prosperity is indivisible has found practical expression in the readiness of countries to co-operate in policies designed to ensure a high and expanding volume of world trade, and these policies have proved remarkably effective, as is shown by the fact that, apart from a minor set-back in 1952, the volume of world trade has been rising steadily, year by year, ever since the end of the war.

6. But whatever other countries do, the rate of progress which we shall achieve, and the increase in living standards which we shall attain, will depend mainly on our own enterprise and our own efforts. It is not sufficient that we should have the capacity simply to produce more. We must be able to produce and sell abroad enough exports to pay for essential imports of food and industrial materials and at the same time to meet the cost of our overseas capital commitments and to build up the reserves. This means producing the kind of goods our overseas customers want, at prices they are willing to pay. In the increasingly competitive conditions which have developed in world markets in the last few years, continually rising costs and prices in this country must inevitably weaken the whole basis of our export trade; and if we do not export enough, we shall be unable either to support a steady expansion of production at home or to maintain full employment. Quite apart therefore from the serious economic and social strains they create, rising prices endanger the full realisation of the possibilities of economic progress, and it must be one of our major objectives to maintain in future a much greater degree of price stability than has been achieved in the past ten years.

III.—Prices since 1945

7. The White Paper of 1944 stated that " It must be regarded as the duty of both sides of industry to consider together all possible means of preventing a rise in the costs of production or distribution and so avoiding the rise in prices which is the initial step in the inflationary process." This need for joint action was again stressed in White Papers in January 1947 (Cmd. 7018) and in February 1948 (Cmd. 7321). Yet in fact between 1946 and 1955 the prices of the final output of goods and services of all kinds increased by about 50 per cent.* Apart from the relatively minor effects of changes in subsidies and indirect taxation, which are dealt with in paragraph 10, these prices are

* A definition of this price index, and index numbers showing changes in costs and prices between 1946 and 1955, are given in the Appendix.

determined partly by the prices of our imports and partly by our own costs of production. These costs of production are themselves determined by the incomes of those who produce the goods and services at each stage of the productive process—in other words, by wages and salaries and profits. Increases in incomes need not necessarily lead to rises in costs and prices, but they do so when they rise proportionately more than production, so putting up costs per unit of output.

8. The level of incomes depends on the balance of supply and demand throughout the economic system as a whole. If demand is significantly in excess of the supplies available to meet it, the pressure of demand will itself contribute to forcing up prices. Prices can also be forced up by pressure for higher incomes even when the level of demand is not excessive. But, generally speaking, the higher the level of demand in relation to supply, the easier it becomes to obtain larger money incomes and to pass on any resultant increases in costs in the form of higher prices.

9. The history of prices since the war falls broadly into five phases :—

(i) The immediate legacy of the war was an accumulation of demand, combined with a shortage of goods due to the dislocation of production. World prices therefore rose sharply, and from 1946 to 1948 the average prices of our imports increased by 25 per cent. This increase would, if it had been the only factor at work, have raised the average level of our final prices by about 5 per cent. But it was accompanied by an excess of demand inside this country and by widespread pressure for higher incomes; and because this increase in incomes outstripped the growth of output, costs of production rose, the rise being reflected in an increase not of 5 per cent., but of 15 per cent., in the average level of prices.

(ii) During 1948 and 1949 incomes did not increase much faster than output, and costs of production were therefore more stable. Since at the same time world supplies were becoming more plentiful, import prices also were rising less fast. As a result, our own final prices rose appreciably less steeply (by 3 per cent. between the two calendar years 1948 and 1949).

(iii) This period of comparative stability was ended by the act of devaluation of sterling in September 1949, which followed the weakening of the sterling area's balance of payments in that year. One of the ultimate causes of that devaluation was the earlier post-war rise in prices; and one of the consequences was a marked rise in import prices, measured in sterling. Then, in 1950, the Korean War provoked a fresh outburst of world demand, particularly for primary products; and import prices rose sharply. This resulted in a rise in retail prices in this country, which itself initiated a demand for compensating increases in incomes. These increased incomes added substantially to costs, because at that time it was proving difficult to increase output : shortage of steel retarded production in 1951, and the lower levels of home and overseas demand for textiles, clothing and other consumer goods, which were in part a reaction from the conditions created by the Korean War, led to an actual fall in industrial output in 1952. In the event, our final prices rose by 23 per cent. between 1949 and 1952.

(iv) The reduction in the food subsidies and changes in indirect taxes in 1952 had two effects. They added a little to prices in the latter part of that year and in the early months of 1953. They also will have helped to reduce the pressure of demand. After 1952 the growth of production was resumed. These last two factors together resulted in a second period of comparative stability. Home costs rose by about 4 per cent. between 1952 and 1954, that is by about the same as in the previous period of comparative stability from 1948 to 1950. Moreover, the effect on final prices was further mitigated by the fall in import prices which occurred during 1952 and 1953. As a result, final prices rose by less than 2 per cent. between 1952 and 1954.

(v) Towards the middle of 1954 import prices began to rise again and the upward trend of home costs accelerated as the tendency for incomes to rise faster than output was accentuated. The combined result has been the renewed upward pressure on costs and prices which continued throughout 1955. This is reflected in a further increase in final prices of 3 per cent. between 1954 and 1955.

10. This brief summary of the course of our final prices in the past ten years has inevitably compressed into a few paragraphs a highly complex process. But there are certain features which stand out :—

(*a*) Since 1946 the prices of the final output of goods and services of all kinds have risen by about 50 per cent. Of this increase about one-seventh is attributable to the net effect of changes in subsidies and indirect taxes. The rest has been determined by movements in import prices and in our own costs of production.

(*b*) Since 1946 the prices of our imports of goods and services have risen by about 70 per cent., partly as a result of the devaluation of sterling in 1949. In the same period money incomes per unit of output have increased by about 45 per cent. But for the economy as a whole our own costs of production, as measured by money incomes per unit of output, are between four and five times as important as import prices in terms of their effect on final prices. Thus, although the rise in import prices has been greater than the rise in our own costs of production, it is the latter which have been responsible for by far the greater part of the increase in our final prices.

(*c*) Although import prices have risen substantially since 1946, the upward trend has not been continuous. Whenever they have risen they have not only added directly to our price level, but also initiated demands for higher incomes, the result of which has been greatly to magnify the immediate impact on the price level of the rise in import prices themselves. This process, which has proved irreversible, has established, from time to time, a new and permanently higher level of prices in this country. That level has never fallen when import prices have fallen, because the gain from lower import prices has been more than offset by the rising trend of incomes and costs at home.

11. Much of the rise in prices in the United Kingdom since the war has been due to the quite abnormal world conditions which were associated first with recovery from the war and subsequently with events in Korea; and our own experience has been shared in varying degrees by most other industrial countries. But even apart from these abnormal factors there has been in this country—to a greater extent than in many other countries—a continuing tendency for prices to rise as incomes increase faster than output. These tendencies have been manifest even when more normal conditions of peace-time full employment have prevailed. This is what gives ground for concern. For if these tendencies persist, and incomes go on rising faster than output over the economy as a whole, full employment will continue to be associated with rising prices and with all the consequent economic and social strains which are discussed in Section V.

32061 O—59——26

IV.—Changes in the Distribution of Income

12. Thus, of the factors which determine the level of final prices the most important is our own costs of production, that is, our own incomes and productivity. It is not possible to analyse the extent to which changes in different categories of income have contributed to the increases in costs of production, and so to the rise in prices discussed above. But the relative movements of these categories of income over a period of years are of obvious relevance and public interest. They are shown in Table 1.

TABLE 1

CHANGES IN INCOMES BEFORE TAX

	£ million	Index (1938=100)	Shares in total domestic incomes(1) (Per cent.)
Wages and salaries			
1938	2,830	100	58
1948	6,140	217	58
1955	10,040	355	60
Income from self-employment(2)			
1938	647	100	13
1948	1,328	205	13
1955	1,702	263	10
Gross trading profits of companies and public enterprises(3)			
1938	764	100	16
1948	2,018	264	19
1955	3,274	429	19
of which:			
Gross trading profits of companies(3)			
1938	690	...(4)	14
1948	1,790	...	17
1955	2,867	...	17
Gross trading profits of public enterprises(3)			
1938	74	...(4)	2
1948	228	...	2
1955	407	...	2

(1) Before providing for depreciation and stock appreciation. Only the main categories of domestic income are shown. Rent, the pay of the Forces, and employers' contributions to the National Insurance Fund and superannuation schemes are not included. The percentages in the right-hand column do not therefore add to 100.

(2) Incomes of farmers, professional persons and other sole traders and partnerships before providing for depreciation and stock appreciation.

(3) Before providing for depreciation and stock appreciation.

(4) Indices are not given as the coverage of each of the two series is affected by successive acts of nationalisation and denationalisation. The combined series for companies and public enterprises is comparable throughout.

Source: 1938 and 1948—*National Income and Expenditure, 1955,* Tables 1 and 2. 1955—preliminary estimates.

13. This table shows that four-fifths of the incomes earned in this country consist of wages and salaries and the gross trading profits of companies and public enterprises; that the total of wages and salaries is about three times as great as the total of gross trading profits; that the latter showed a considerably greater proportionate rise than the former between 1938 and 1948; and that both types of income have risen at a more or less equal rate—by nearly two-thirds—in the period between 1948 and 1955.

14. The distribution of gross profits as between dividends, taxes and reserves is a separate question. Table 2 provides estimates of the allocation of the total income of companies from their trading and other activities in the years 1938, 1948 and 1955.

TABLE 2

THE APPROPRIATION OF COMPANY INCOME(1)

	£ million			Per cent. of total		
	1938	1948	1955	1938	1948	1955
Dividends on preference and ordinary shares(2)	481	512	772	47	22	21
Other interest payments, &c.(3) ...	160	206	442	15	9	12
United Kingdom taxes on income(4)	95	743	884	9	31	24
Saving before providing for depreciation and stock appreciation(5)	299	895	1,596	29	38	43
Total income of companies (6)	1,035	2,356	3,694	100	100	100

(1) The coverage of this table is affected by successive acts of nationalisation and denationalisation. It relates to companies in private ownership at each date.
(2) Dividends paid by one company to another are excluded.
(3) Debenture interest, co-operative society dividends and interest, interest on building society shares and deposits, other interest paid by banks, &c., and taxes and remittances paid abroad.
(4) Includes additions to tax reserves.
(5) Includes additions to dividend reserves.
(6) Gross trading profits of companies operating in the United Kingdom as in Table 1, plus trading profits earned abroad and non-trading income.

Source: 1938 and 1948—*National Income and Expenditure, 1955*, Table 29. 1955—preliminary estimates.

15. This table shows that in 1938 dividends—in the sense in which they are normally understood, *i.e.*, dividends on the preference and ordinary shares of companies—absorbed nearly one half of the total income of companies; taxes took 9 per cent.; and reserves, together with depreciation, less than 30 per cent. The balance of about 15 per cent. consisted of a variety of other types of interest payments, together with payment of taxes abroad. In both 1948 and 1955 dividends took a little over 20 per cent. of total company income; taxes accounted for between one-quarter and one-third; about 40 per cent. was set aside to provide for depreciation and stock appreciation charges or put to reserve; and the balance of some 10 per cent. was absorbed by the other items.

16. Dividend payments by companies now constitute about 5 per cent. of the total of incomes analysed in Table 1, and their relevance to the movement of prices lies much less in their direct effect on the level of incomes than in the pressure which they are liable to generate for what are felt to be corresponding adjustments of wages and salaries. Table 3 compares the movement of dividends over the period 1938–1948–1955 with the movement of wages and salaries. The figures for wages and salaries are the same as those in Table 1 and cover all incomes of this kind, in whatever industry or occupation they are earned. Corresponding changes for dividend payments cannot, however, be calculated directly from Table 2 because the coverage of the figures in that table is affected by successive acts of nationalisation and denationalisation. To ensure the same coverage throughout, the estimates used in Table 3 are those of dividends paid on ordinary and preference shares by companies which were not nationalised at any time during the period 1938 to 1955.

TABLE 3

CHANGES IN WAGES AND SALARIES AND DIVIDENDS(1)

	Wages and Salaries		Dividends(1)	
	£ million	Index 1938=100	£ million	Index 1938=100
1938	2,830	100	426	100
1948	6,140	217	470	110
1955	10,040	355	766	180

(1) Dividends paid on preference and ordinary shares by companies which were not nationalised at any time during the period 1938 to 1955. Dividends paid by one company to another are excluded.

Source: 1938 and 1948—*National Income and Expenditure, 1955*, Tables 2 and 30. 1955—preliminary estimates.

17. These estimates, which take no account of direct taxation, show that between 1938 and 1948, while prices of consumers' goods and services* roughly doubled, wages and salaries rather more than doubled, and dividends of non-nationalised companies rose by about one-tenth. Over the period 1948 to 1955, while consumer prices rose by nearly one-third, both wages and salaries and dividends increased by nearly two-thirds, dividends having in the last few years caught up with wages and salaries. Taking the period 1938–1955 as a whole, wages and salaries have increased by very much more than dividends; and the real value of wages and salaries has increased by 40 per cent. over this period, while that of dividends has decreased by 30 per cent.

* The price index used for these calculations covers prices of consumers' goods and services of all kinds (Item 5 in the Appendix).

V.—Price Stability and Economic Progress

18. Earlier sections of this paper have referred to the possibility of future economic expansion, and have discussed the forces which have made for rising prices since 1945. Unless the upward pressure of rising money incomes on prices is moderated, the economy is likely to be exposed to serious and increasing strains. These strains, if not relieved, will prevent us from realising the full potentialities of economic growth and may lead to unemployment by making it more difficult to secure our imports.

19. Our overseas earnings must be increased if we are to pay for the imports needed to sustain an expanding economy, to provide for overseas investment and to build up our reserves. The necessary expansion of exports will depend for its realisation on two factors—first, a continuing growth of production and trade throughout the world; second, our own ability to secure a sufficient share of this growing trade. The Government's policies are directed, in co-operation with the Governments of many other countries, to securing the maximum expansion of trade and to creating conditions in which this trade can flow freely. But no efforts of Government alone can ensure that this country reaps the fullest advantage from the expansion of world trade.

20. An adequate volume of exports will depend above all upon the competitive strength of our goods in overseas markets. That strength is itself the outcome of many factors—the quality of the product, promptness of delivery, effective salesmanship, good after-sales service, and so forth. But the basic factor is price. Unless our prices are fully competitive, our exports will be inadequate for our vital national needs, our currency will not retain its value in world markets, and unemployment will result from shortage of imported raw materials.

21. Competition in overseas markets is keen; and this country no longer enjoys the pre-eminent position which it held during the last century. To-day we have to match ourselves against formidable rivals, not only in foreign markets, but in the Commonwealth as well. The dislocation caused by the war left the United States of America the only important source of supply for many goods; and the United States' share of world trade in manufactures* has risen from about 20 per cent. in 1937 to about 25 per cent. to-day. As against Western Germany we enjoyed a considerable advantage in the years immediately after the war; even as late as 1950, her share of world exports was little more than 7 per cent. To-day it is more than double that figure. Over the same period the total volume of world trade in manufactures has risen by over 40 per cent.; but our own share has fallen from over 25 per cent. to about 20 per cent.

22. A country's share of world trade is affected by many factors apart from its competitive power, and too much weight should not be attached to the precise percentage at any single point in time. But a continuing downward trend in the share must inevitably be a cause of concern if it reflects the fact that exports are not increasing sufficiently to meet a growing import bill and to finance other external commitments. Such a situation must be corrected.

23. A weakening of the balance of payments is the most obvious and immediate consequence of a disproportionate rise in costs and prices. But

* Strictly, the exports of manufactures of 11 main exporting countries, *i.e.* (in order of importance in 1955) the United States, United Kingdom, Western Germany, France, Canada, Belgium-Luxembourg, Japan, Netherlands, Switzerland, Italy and Sweden.

such a rise, if it persists, has other, and no less serious, effects at home. The future growth of the economy will depend upon a sustained expansion of investment; and the rate of investment which we can afford will depend on our willingness to save. The full effect of continually rising prices on savings is unpredictable; but it is clear that they can progressively undermine the whole relationship between borrower and lender and thus the accepted structure of savings. That structure rests, to a considerable extent, on the willingness of the lender to hold, for long periods, titles to fixed sums—in the form of Savings Certificates, Government securities, insurance policies, debenture stock, and so forth. This willingness itself derives from a basic confidence that money will broadly retain its value. In so far as rising prices impair this confidence and thereby reduce people's willingness to save, the financing of investment becomes more difficult and more expensive, industrial development is retarded, and the pressure on prices is accentuated. This is particularly serious, because the necessary expansion of production, with a labour force that is not likely to expand much further, will depend on a sustained expansion of investment. A high rate of investment cannot be achieved if too much of our wealth is devoted to consumption, and attempts to maintain both simultaneously at levels we cannot afford only result in further inflation.

24. But the effects of a rising price level have a much more direct and more immediately personal impact. Continually rising prices are an obvious social evil. For many people this evil is obscured by the fact that they either are, or believe themselves to be, able to secure increases in their incomes to offset the rise in prices; and although their pressure for higher incomes itself adds to the pressure on prices and they do not in fact gain very much from the rise in incomes, at least they do not lose very much from the rise in prices. Even so, the spiral of rising incomes and prices is a cause of considerable personal anxiety and of an acute sense of social unfairness. The difficulties and hardships inherent in such a situation bear most heavily on those dependent on fixed incomes, who are in continual danger of having their standard of living progressively reduced. The longer this process continues, the more arbitrary its effects appear, and the more sharply the sense of injustice is felt.

VI.—The Conditions of Price Stability

25. The Government is pledged to foster conditions in which the nation can, if it so wills, realise its full potentialities for growth in terms of production and living standards. But the Government must no less seek to ensure that the pressure of domestic demand does not reach a level at which it threatens price stability and endangers the balance of payments. To maintain full employment without inflation necessarily involves continual adjustments. At times the pressure of demand will grow too strong and will need curbing; at other times this pressure will be weak, and the economy will need a stimulus. It is the Government's job to keep the pressure right, and adjustments will have to be made from time to time in fiscal, monetary and social policies in order to achieve this result. But the ultimate aim will always remain essentially the same—the encouragement, by all the means which the Government commands, of the general climate most favourable to the maximum development of a balanced economy. This demands continuing attention to the problems discussed in Section V; as a nation whose lasting prosperity depends on a high level of overseas trade, we simply cannot afford to allow excessive demand at home to undermine our competitiveness in world markets or to take too much of the output that we need to sell abroad to secure our essential imports. We must guard against the false

sense of internal prosperity that can be given by continually rising money incomes unaccompanied by the necessary levels of output and exports, which cannot last and must ultimately endanger our long-term prosperity, and with it the whole ideal of full employment as a feature of our national economy.

26. In order to maintain full employment the Government must ensure that the level of demand for goods and services is high and rises steadily as productive capacity grows. This means a strong demand for labour, and good opportunities to sell goods and services profitably. In these conditions it is open to employees to insist on large wage increases, and it is often possible for employers to grant them and pass on the cost to the consumer, so maintaining their profit margins. This is the dilemma which confronts the country. If the prosperous economic conditions necessary to maintain full employment are exploited by trade unions and business men, price stability and full employment become incompatible. The solution lies in self-restraint in making wage claims and fixing profit margins and prices, so that total money income rises no faster than total output. In the absence of such self-restraint, it may seem that the country can make a choice—albeit a painful one—between full employment and continually rising prices, or price stability secured with some danger to the level of employment that might otherwise have been achieved. But soon looms up the grim danger that the first of these apparent alternatives will turn out to have been no alternative at all, because we may fail to secure sufficient imports to maintain full employment and our present standard of living.

27. How fast output rises depends on our success in raising productivity. The achievement of a sustained increase in productivity calls for contributions from both management and labour. Management must strive to ensure the maximum expansion of output by progressive investment in the most efficient capital assets, by the introduction of the most modern industrial techniques and by the elimination of all restrictive practices which inhibit the economic growth of production. The contribution of labour lies in co-operating to the full in the adoption of new methods of working and in setting aside all practices which, however much they may have been justified in the past as means of safeguarding status, conditions of work, or the security of employment itself, are not appropriate in conditions of full employment.

28. The healthy functioning of the economy and the progressive growth of its output depend also on co-operation within industry in maintaining an efficient and enlightened system of industrial relations. The relationship between management and workers which this implies is a vital but intangible factor which only they can create by common effort. It demands a full and frank exchange of opinion and information at all levels between representatives who have confidence in each other's competence and integrity. If this confidence is achieved and maintained, the gain, in terms both of physical output and of human relations, can be incalculable. If not, the resulting discontent and friction will impede production and hamper exports, thereby discrediting British industry abroad as well as at home.

29. Efficient methods of work and sound industrial relations should result in a sustained growth of productivity, yielding economic production and competitive prices. How well off we are as a nation depends not on the sum total of the money incomes we earn, but on the sum total of the goods and services we produce; and as individuals it is what we can buy with our pay rather than the pay itself which determines our standard of living. Price reductions can therefore contribute to raising our standard of living just as

much as increases in money incomes, and so far as practicable it is through price reductions that we should aim to enjoy the benefits of higher productivity. If we all press constantly for more money, regardless of how much we produce to spend it on, prices are bound to go on rising. But if we concentrate on increasing productivity, and on keeping costs down, price stability can be achieved along with full employment and a rising standard of living.

30. From the point of view of industry and trade this means that firms should try, wherever possible, to pass on gains from higher productivity in lower prices and to expand their profits not by the maintenance of high profit margins, but by the expansion of turnover. This will be easier to achieve in some sectors of the economy than in others, since the scope for increasing productivity will vary—not because of better or harder work, but because of differences in the amount of capital employed, varying rates of technical progress, changes in the pattern of demand, greater opportunities for securing economies from increased output and so forth. If general price stability is to be maintained, it is essential that there should be a positive reduction of prices in those sectors in which productivity tends to rise more rapidly than the average. Enterprises which can achieve an increase of output and sales by a reduction of costs, including profit margins, will be making a real contribution to the maintenance of price stability and to the whole process of balanced economic growth.

31. The counterpart of realism in relation to prices is realism in relation to personal incomes. The Government of this country does not attempt to tell the people what income each one of them ought to be receiving at any given moment. Wages are fixed by free negotiation between employers and workpeople, within a system of collective bargaining which has been built up over a long period of years. By equally well established practice, the level of dividend declared by a company is a matter for recommendation by the directors and confirmation by the shareholders. But the satisfactory operation of this whole system depends upon everyone involved being fully aware of the issues at stake, and upon their acceptance of the full duties of citizenship which this realisation places upon them. If they always place sectional interests before the nation's welfare, economic stability will be endangered and the possibilities of future expansion impaired, possibly to the extent of jeopardising those very sectional interests which they seek to protect.

32. We all want full employment and we all want stable prices. But we have not yet succeeded in combining the two. The experience of the past ten years has shown that the fuller employment is the more liable prices are to rise; but the Government does not believe that there is any inevitable conflict between the two objectives. We can achieve them both if certain conditions are fulfilled; and it has been the aim of this White Paper to state what these conditions are, in the belief that a greater awareness of the nature of the problem will contribute to finding a solution for it.

APPENDIX

INDICES OF PRICES AND COSTS SINCE 1946 (1948 = 100) (1)

	1946	1947	1948	1949	1950	1951	1952	1953	1954	1955	Percentage increase between 1946 and 1955
1. Prices of imports of goods and services	81	93	100	102	118	149	143	132	132	137	69
2. Home costs per unit of output(2) ...	90	94	100	103	104	111	122	125	127	130	44
3. Price index of final output(3)	87	94	100	103	107	119	126	127	128	132	52
4. Prices of exports of goods and services	84	92	100	103	110	130	138	130	128	130	55
5. Consumer price index(4)	87	93	100	102	106	114	121	123	126	130	49
6. Interim index of retail prices(5) ...	..	93(6)	100	103	106	116	126	130	132	138	..

(1) Except for Item 6, the series in this table for 1946 to 1954 are currently weighted price indices derived from *National Income and Expenditure, 1955*, by comparing current price estimates with similar estimates at 1948 prices. The figures for 1955 are preliminary estimates.

(2) This index is obtained by dividing estimates of total domestic income (*i.e.*, wages, salaries, gross profits and other trading income, after providing for stock appreciation) by estimates of the gross domestic product at 1948 factor cost.

(3) This index relates to the prices of all goods and services produced for consumption, investment and exports.

(4) This index relates to the prices of all goods and services bought by personal consumers.

(5) This index relates to the prices of those goods and services bought by working-class families. It differs from the consumer price index in various ways—for instance, by giving a greater weight to food prices (which have risen more than the average). There is no retail price figure for 1946 comparable to that for the later years.

(6) Figure for June 1947.

APPENDIX B

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