INTERNATIONAL MONETARY FUND

FINAL MINUTES

Executive Board Meeting 331

1818 H Street, N. W.

10:00 a.m., June 25, 1948

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C. Gutt, Chairman

E. de Selliers
W. Koster
G. H. Tansley
G. Cigliana-Piazza
R. Martinez-Ostos

J. V. Joshi
Y. C. Koo
J. de Largentaye

R. Wilson
M. Kolovic

J. V. Mladek
A. N. Overby

J. F. Parkinson
M. S. Falaki
O. Paranagua

R. L. Horne, Acting Secretary
P. Thorson, Assistant

Present for Items:
3-6 E. M. Bernstein, Head, Research Department
3 R. Bertrand, Research Department
4-6 W. M. Allen, Research Department
4-6 P. J. Brand, Operations Department
3-6 R. Brenner, Legal Department
3 H. M. Bompard, Research Department
4-6 W. Drees, Research Department
3-6 E. P. Hexner, Legal Department
3 E. Hicks, Research Department
4-6 B. Rose, Research Department
3 G. M. Salle, Operations Department
3-6 W. H. Taylor, Operations

Approved: Meeting 343
July 16, 1948

1. Minutes

The minutes of Meeting 327 were agreed as revised.

2. Applications for Membership - Albania, Liberia, Pakistan and Siam

The applications for membership from Albania, Liberia, Pakistan and Siam were considered (Executive Board Documents Nos. 280, 281, 282 and 283; Meeting 329, Item 6). One Executive Director inquired whether the applicants were members of United Nations.

The decision was:

The Fund should proceed with formal investigations of the applications of Albania, Liberia, Pakistan and Siam for membership in the Fund (Executive Board Documents Nos. 280, 281, 282 and 283). The following Committee is designated to obtain relevant information, discuss any related matters with the applicants and report to the Executive Board: Messrs. de Largentaye, Chairman; Kolovic, Koo, Joshi, Overby and Tansley.

3. Exchange Situation - Italy

The Executive Board discussed the exchange situation of Italy giving particular attention to recent financial developments (Staff Memorandum No. 248). After remarks on some of the figures given in the staff paper, such as the loan-to-deposit ratio which appeared to be at a higher level than the figures given by Banca d'Italia, Mr. Cigliana made a general statement. He pointed out that the new Government had been in existence only a few weeks and therefore only the general outline of its financial program was available. As stated by the Prime Minister, the main points of that program were as follows:

(a) Severe revision and limitation of expenditures, with elimination of the political prices, so as to reduce total expenditures substantially.

(b) Reorganization of the fiscal system, which should materialize within this year.

(c) Maintenance of the present credit policy.

(d) Readjustment of the budget, looking toward balance in the course of the next two or three years.

(e) Careful use of national currency proceeds from ERP in order to derive the maximum benefit for the national economy.

Remembering that Italy's reconstruction had proceeded more quickly than expected, Mr. Cigliana pointed out that this had brought an increasing financial pressure which had been recently checked to a certain extent by several measures as described in various staff papers. Since January 1947 the Central Bank had persistently encouraged more orthodox policies in the commercial banks so as to dissociate them from the spiral of increasing demand for new financing. As a result the loan-to-deposit ratio had been lowered and banks are today in a better position of liquidity.

Regarding the impact of unemployment, Mr. Cigliana recalled the Chairman's statement as to the difficulty of stopping inflation until the unemployment problem had been solved (Meeting 223, Item 2). A considerable part of the increased budget expenditure in the last two years had arisen from the unemployment problem; examples were measures such as extraordinary public works, the so-called "political prices" and assistance to industries to meet excessive labor and wages. As for trade, he noted that, even though Italy had a net trade surplus within Europe, she suffered from the loss of some traditional markets and the general difficulties of the European situation. If anything, her economy was even more susceptible than others to the over-all lessening of trade and the growing competition due to her deficiency in raw materials, her pattern of exports and the increasing population pressure.

3. Exchange Situation - Italy (Cont'd)

Mr. Cigliana noted that the dollar exchange rate for exports had remained between 573 and 575 since November 1947, and black market quotations were now often below the official rates. Wholesale prices had declined, due among other reasons to the appreciation of the lira as against the dollar brought about by a revival of confidence in the Government's policies and reflected in reduced prices for some imports; the increased domestic production meeting with certain difficulties in finding adequate outlets, and the substantial repatriations of private dollar assets through the "free of exchange" system. About $138 million had been repatriated through "franco-valuta" imports under this system, greatly increasing the supply of several commodities. After this satisfactory result, the "franco-valuta" imports were discontinued since the beginning of June. The cost of living had held about stable since February 1948 after a fall of around ten per cent over the four months preceding. Recent information indicated that a good cereal harvest was expected; wheat should total close to 60 million quintals. Labor productivity in industry, which had fallen off before the elections, was reported back to normal by May. Industrial activity had also recovered to about the level of last October.

In conclusion, Mr. Cigliana said that Italy looked upon ERP not only as a source of immediate material benefits for which she is deeply grateful, but also as a strong moral obligation to put her house in order financially and increase her production. She regarded the Program as one of the most important driving forces in history towards European understanding and constructive co-operation. Among the proofs of this good will on the part of Italy were the conversion and resumption of service on the Italian foreign debts, the several new commercial agreements, the new law on foreign capital, and the financial policy recently enunciated by the Government.

In discussion the staff representatives noted apparent paradoxes in Italy's financial experience. One was that substantial unemployment and low production had continued in spite of a long and steady inflation during which prices had advanced faster than costs. The explanation of this anomaly was not clear; evidently, however, several important segments in the economy were incapable of responding to monetary demand. For one thing, in industry both equipment and raw materials were in short supply. Italy's markets, which were normally in Europe, had also been partly closed off. On the farms the excess population did not result in greater output. Large public works projects had been undertaken to provide employment, but such enterprises did not solve Italy's need for consumer goods.

Another apparent paradox was the considerable deflation and money shortage which had appeared, even though the budget remained unbalanced and the rate of credit expansion was merely slowed. Business enterprises had complained at the credit shortage and had been brought to repatriate substantial capital through "franco-valuta" imports. More unemployment had been threatened and there was considerable clamor for a resumption

3. Exchange Situation - Italy (Cont'd)

of the old inflationary policies. Several factors had apparently contributed to the money shortage. One was that when prices levelled off after the credit restrictions, businesses found themselves unusually short of cash because they did not realize the expected profits from the inflation in prices during the production cycle. At the same time, consumers were willing to hold more cash when prices levelled off. The result showed all the symptoms of a considerable deflation.

The staff believed the Government should not relax its policies so as to ease the credit situation, since there is still the danger that another round of inflation would begin. Evidently there had been some lag in translating budget deficits into actual increased monetary circulation. However, the effect was bound to be felt in some months. In addition, credit was still being expanded, although at a reduced rate. The hope was that there might be a period of relative stability or only moderate price rises during which, with the help of ERP and other arrangements, the economy could be put on a stronger footing. However, in any case, further efforts to balance the budget and control credit expansion would be essential to long-range stability.

As for the exchange system, the staff representatives pointed out that a fixed rate could hardly be successful in an economy where prices rose 50 per cent or more a year. The flexible system adopted was reasonably satisfactory in the circumstances and did have the merit of encouraging exports as against imports in an economy of steadily rising costs. They believed disparate cross rates were not a necessary consequence of fluctuating rates. There was some hope that, if prices could be maintained in reasonable stability, Italy might be able within a year or less to begin discussions on the prospect of establishing an exchange rate that could be maintained.

There was a discussion of the problems of tapering off a rapid inflation without inducing a severe deflation. The point was made that the sudden shift in the public's liquidity preference when prices stopped rising probably made a temporary cash shortage likely even though the money supply had been greatly expanded. It was noted too that in Italy's case the shortage of cash had been increased by rising costs, including a 20 per cent wage increase, even though prices were stable. There was a discussion on purchasing power parity comparisons for Italy, the kinds of assistance which Italy might receive under ERP, and similar questions.

Mr. Tansley pointed out that neither the staff study nor the discussion had dealt with the Italian exchange system or the resulting problem of disparate cross rates. His Government, and he believed other governments, were especially concerned about those aspects. He thought that there could with advantage be an early discussion of those subjects.

3. <u>Exchange Situation - Italy</u> (Cont'd)

At the conclusion, the Executive Board took note of the staff study's conclusions on Italy's financial position. It was noted the situation should be kept under review and that other aspects, such as the fluctuating rate system and its consequences, would be discussed at a later time.

4. Exchange Situation - British Dependencies

There was a discussion of the exchange position of the U.K. dependencies and their significance for the sterling area (Staff Memorandum No. 249). The point was made that in prewar years the dependencies, taken together had been substantial earners of U.S. dollars. Their dollar earnings had been severely cut by war damage, unusual demands for imports, and relative disadvantages in the prices for some products, such as rubber and gold. Although they normally had a sizeable favorable balance over-all, in recent years they had actually been a net drain on the U.K. However, if the former position could be regained, a substantial part of the sterling area's dollar problem could be met. They could both earn considerable dollars directly and supply the U.K. with goods which otherwise would require dollar outlays. The staff view was that because of this special significance, others beside the sterling area members should be vitally interested in restoration of the dependencies' position.

Various aspects were discussed. One question involved the feasibility of direct dollar investments in the dependencies for reconstruction and development rather than capital investments made through the U.K. The reply was that while traditionally there had been little direct dollar participation, such investments could be advantageous and some might well be discussed.

Mr. Tansley commented on the usefulness of the study which had been made. He believed, however, that the study and an earlier one on the sterling area (Staff Memorandum No. 239) might have examined some of the considerable trade advantages which the dependencies gained from their sterling area relation. They were enabled to buy essential goods for sterling in countries where they might have no purchasing power if they were operating bilaterally and to sell goods for which the purchasing country would not be able to pay in any other useful currency. Without the arrangements, the total volume of world trade would be cut. A staff analysis on the point was promised.

5. Exchange Situation - United Kingdom

The Executive Board continued its country reviews with a study of the U.K. exchange position (Staff Memorandum No. 250). Mr. Tansley noted that the U.K. economy was continuing its progress. He believed that the continuing rise in exports was encouraging. The export volume in May, he noted, was 134 per cent of the 1938 rate.

Staff members said they believed the most significant feature of the current fiscal year was the substantial increase in the budget surplus. This made it unlikely that new inflation would be generated currently within the economy. Probably savings, including the budget surplus, during the year would exceed the targets established for capital formation. That fact, together with other improvements and the ERP aid might imply the possibility of increases in capital formation, particularly in the industrial area.

Other figures were also encouraging. Productivity appeared to be rising. The external trade position was better than in '47 although not as good as had been hoped. The import volume was about as planned; however, the cost was substantially increased because of price rises. There probably would be a greater drain on gold and dollar reserves than had been planned, and the drain was expected to continue in 1949, even in spite of ERP aid. The belief was that the UK would be fortunate if it could maintain its gold and dollar holdings above $2 billion. There was some hope of achieving an over-all balance in payments in 1949 even though the hard currency payments would still be in deficit.

In view of the U.K. maintenance of the export program, the staff saw no reason at this time to believe that a change in the par value for sterling would be helpful. They did note, however, that U.K. export prices were rising slowly relatively to export prices for U.S. manufactures. While the difference was at present unimportant, a continuation might have a noticeable adverse effect and should be watched.

Various points were discussed. A question was raised as to a statement in the staff study that, in certain circumstances the U.K. might in the next year "wish to seek dollar credits additional to those provided under ECA." The staff representatives said the assertion had referred primarily to possible development credits for the U.K. dependencies (See Item 4 above). They added that there was some possibility the U.K. would incur increased deficits under payments agreements with certain European countries. In that case she might not be able to avoid coming to the Fund for such currencies, even though she might prefer not to. Mr. Tansley said he did not believe the U.K.'s credit needs could be fruitfully discussed at this time until there was a better indication of developments under the ERP.

At the conclusion the Executive Board took note of the conclusions which the staff had presented on the U.K. exchange position.

6. Gold Production Subsidies - Southern Rhodesia

Mr. Tansley said that the U.K. Government had made inquiries after reports that a gold subsidy proposal had been included in the recent budget of the Southern Rhodesian Government. Upon learning the nature of the proposal, the U.K. had suggested that the Southern Rhodesian Government should modify their proposal. A reply was received which indicated that, while the Government would be only too willing to consider modifications, it felt compelled to proceed with the pending legislation which would be effective until March 31, 1949. The production plans for that period had been based on the proposals; any change on short notice would be impractical.

The Rhodesian reply had further stated that the plan did not envisage a flat subsidy to all producers, as had been reported. It provided a minimum payment of £ 1:7:6 per ounce for all production with additional benefits up to £ 1 per ounce for mines of economic value to Southern Rhodesia which otherwise would have to close. The subsidy was considered to be more in the nature of a cost-of-living payment to the industry to compensate for sharply increased costs. The Government believed that a system based upon the cost of production of individual mines, such as in the Canadian plan, would be unsuitable, since a large part of the production came from small mines, where the determination of production costs would be difficult. They also feared that the net cost of such a plan to the budget would be larger than the more general system proposed. They were informed this had been the case in Canada. The Southern Rhodesian Government was not prepared to assume any additional burden.

Mr. Tansley concluded by saying that the U.K. Government felt that they had gone as far as possible in drawing the attention of Southern Rhodesia to the difficulties inherent in their proposal and in urging them to revise it. However, Southern Rhodesia was in fact a self-governing territory. Hence, the U.K. was not in a position to require action. In addition, Southern Rhodesia was not a member of the Fund on its own account.

Mr. Overby said he believed this statement raised serious questions as to what party was to be considered as the member in this case, what the obligations to the Fund were and to which party the Fund would look to observe the obligations. He asked that the matter be discussed more fully after the staff could made a study.

There was agreement that the question of the Southern Rhodesian gold subsidy measures should be discussed when a study by the staff on all pertinent aspects was available.

7. <u>Governors' Meeting Agenda</u>

The Executive Board agreed that an <u>ad hoc</u> Committee on the Annual Meeting Agenda should be established to consider subjects to be placed on the agenda for the Third Annual Meeting. The following members were designated:
Messrs. Koo, Chairman; de Selliers, Martinez-Ostos, Mladek and Overby.