

The Monetary Problems of a Dependent Economy: The Australian Experience 1948-1952

1. - Introduction.

In a review article recently published in this journal (1) I made reference to the special monetary problems likely to confront dependent economies because of the dominating influence exerted upon them by the behaviour of their balances of payments. My aim, on that occasion, was to suggest that both central banking theories and techniques have been unduly coloured by British and United States experience. For most countries, it seems clear, Britain and America are poor models. The latter because its balance of payments is relatively unimportant as a determinant of domestic economic conditions (2). The former because its central banking theory was developed over a period in which Britain was not only the dominant country in world trade and the major industrial power, but London was also an international money and capital market of pervasive influence. The consequence of these special circumstances was that the British balance of payments between 1870 and 1914 did not experience major disequilibria despite considerable cyclical fluctuations in British foreign investment (3).

In recent years the studies of Plumptre, Triffin, Wallich and Simkin (4), have done a great deal to focus attention on the monetary problems of dependent economies. The purpose of this paper is to supplement the im-

(1) D. ROWAN, *Central Banking in the British Commonwealth*, this Review, No. 25, April-June, 1953. Particularly Sections 1 and 2.

(2) Cf. A. I. BLOOMFIELD, *Capital Imports and the American Balance of Payments, 1934-1939*. (Chicago, 1950) and the essay of the same writer in "The New Economies" (Edited by Seymour Harris, London, 1948), Chapter XXII.

(3) Cf. W. EDWARDS BEACH, *British International Gold Movements and Banking Policy 1881-1913*, (Harvard, 1935) and C. K. HOBSON, *The Export of Capital* (London, 1914).

(4) For full references consult my earlier article.

portant work of these writers by a study of Australian experience from 1948-52.

Australia offers a particularly good example of an economy which is both economically dependent and highly developed financially. Moreover, within the short space of the four years 1948-1952, its balance of payments underwent changes of considerable magnitude which inevitably produced repercussions in the monetary field. It is thus admirably adapted to our purposes. Finally, Australia offers an additional advantage in that the nature of its monetary and banking system as well as its central banking techniques are well known, a circumstance which enables us to avoid a great deal of description.

As a case study this paper is necessarily over compressed. This is the consequence of limitations of space which are unavoidably imposed upon journal articles. The reader is therefore warned that there are several omissions from our discussion and that, in particular, the parts played by fiscal policy and debt operations have been largely neglected.

2. - The Problem of Stabilization.

Australian experience from 1948-1952 throws into clear relief the problems which face dependent economies as a consequence of fluctuations in their balances of payments. It is, of course, possible that recent events in Australia rather exaggerate the difficulties, since one may reasonably hope that future fluctuations in exports proceeds will not display quite the severity of 1950-52. Nevertheless, some fluctuations in export proceeds are probably inevitable and these *may* be accompanied, to put matters conservatively,

by parallel fluctuations in private capital inflows induced partly by the attractions of exchange speculation. The problems of other dependent economies may well be qualitatively similar.

The main purpose of this paper is to assess the extent to which the Commonwealth Bank was successful in promoting stabilization policies. What are the criteria of such policies? We shall fall into serious error if we attach too much importance to movements in domestic prices for, given a stable rate of exchange and assuming the absence of marketing schemes which divorce the domestic from the external price of exports (5), a fully employed dependent economy experiencing an export boom *must* accept some degree of inflation. Indeed to do so is in its own interests for, if an attempt were made completely to offset the increase in exporters' incomes by forcing reductions in either consumption or investment, the result might be to purchase price stability at the cost of a serious dislocation of development programmes and a wasteful redeployment of productive resources to meet transitory demands. Moreover, an export boom does not lead only to demand inflation. Wage earners are certain to react adversely to the increased share of the national product going to exporters and to attempt, by wage demands, to maintain the preboom share of labour. Hence, policies directed at stabilizing aggregate demand completely would, if successful, probably involve unemployment.

The plain fact of the matter is that in a fully employed dependent economy inflation is the process through which the gain in real incomes resulting from an improvement in the terms of trade is spread throughout the economy. Any attempt to prevent this process completely is likely to involve labour unrest. It seems therefore that official policy (including central banking policy) should not be exclusively concerned with the prevention of domestic price increases but should aim primarily at maintaining the con-

(5) At present such schemes, at least for wool, are politically unacceptable in Australia. Equally proposals for exchange appreciation in export booms (but not depreciation in recessions) are likely to meet with very strong opposition.

tinuity of essential development projects and the full employment of resources while avoiding the disturbance of labour relations and interruption of the progress of domestic industries. Domestic price increases should be tolerated as long as they do not conflict with these objectives, opposed and prevented as far as possible when they are themselves the causes of distortions.

The abandonment of policy objectives defined simply in terms of price stability makes the evaluation of official policies a matter of considerable difficulty since it is no longer possible to refer to the behaviour of particular price indices as indicators of official success or failure. Evaluation becomes complex and since certain objectives of policy, for example, the avoidance of interruption in the progress of domestic industry, are not readily assessed statistically, involves individual judgments.

The capacity of any central bank to promote stabilization (in the sense sketched above) is limited by three groups of factors. These we may call the economic, institutional, and technical factors.

As we have seen, stabilization in the face of export booms when properly conceived does not involve the complete stabilization of aggregate demand. The concern of official policy (including central bank policy) will therefore be: (a) to prevent increases in other components in aggregate demand for domestic output (in real terms); and, perhaps, more ambitiously; (b) to bring about some reduction in these other components as a partial offset to the export boom.

It seems probable that the components simplest to influence are public and private investment, and — from the central banking point of view — more particularly the latter (6). Accordingly, the scope for central banking action will depend upon the relative importance of private investment. Where private investment is small the scope for central banking control is correspondingly reduced.

Essentially the aim of central banking is

(6) This does not mean that the central bank cannot influence public investment but that its methods of doing so involve its advisory and persuasive functions rather than its management of monetary conditions.

to operate upon private investment by manipulating the availability and cost of finance. This presupposes the dependence of private investment on institutional channels of finance — including in this term both the banking system and the capital market. Where institutional finance is highly developed, central banking is clearly important. Its efficacy however will depend upon the adequacy of the technical weapons at the central bank's command and the quality of its direction.

In the special case of Australia private investment is an important component in aggregate demand while institutional finance is a significant influence in determining it. Indeed the potential elasticity of the Australian money and capital markets is considerable. The economic and institutional factors thus allow wide scope for central banking. Our task now is to assess the quality of the leadership offered by the Commonwealth Bank and the adequacy of the technical weapons at its command. To do this we must first survey the facts.

3. - 1948-1950: The Problem of Capital Inflows.

For most of this period, apart from control over capital issues which was retained until January 1950, the principal control over the economy was exercised by the Commonwealth Bank. Price controls on a Commonwealth basis were discontinued in 1948 in favour of State administration. Control in general became less rigorous. A heavy responsibility for restraining inflation therefore rested upon the monetary authority.

In both 1948-49 and 1949-50, Australia's balance of payments was favourable. Her international reserves rose by £A178 millions in 1948-49 and £A186 millions in 1949-50. These two favourable balances were partly due to an improvement in the terms of trade which was accompanied by rising export incomes. Farm incomes, for example, rose from £A397 millions in 1948-49 to £A548 millions in 1949-50. It seems, however, that the main influence on reserves was exerted by private capital inflows which were £A164 millions in

the former year and £A266 millions in 1949-50 (7).

The significance of private capital inflows for a dependent economy depends upon the nature of the inflow. A purely speculative short term movement exerts its influence primarily through its impact upon bank liquidity. An inflow due to portfolio investment will have similar monetary consequences but may promote buoyant conditions in the capital market. Finally, an inflow arising out of direct investment will add to its monetary influence a direct effect upon incomes. This, of course, assumes that the investment which this inflow finances could not, or would not, have been financed through the local capital market had external finance not been available.

It is impossible to allocate the private capital inflow accurately between these three main categories. There seems, however, to be little doubt that much of the inflow in both years was due to speculation on an appreciation of the Australian pound in relation to sterling. This suggests that the main problem facing the authorities as a result of the capital inflow arose out of its possible monetary effects (8).

Faced with an inflow of short term capital of this kind the monetary authority may carry out either of two restrictive policies in regard to the money supply. These are:

(a) to prevent any « secondary » expansion of the money supply based upon the increase in external reserves;

(b) to prevent both « primary » and « secondary » expansion of the money supply by reducing the domestic assets of the central bank by an amount equal to the increase in its foreign assets.

The second policy is plainly more ambitious than the first and could involve considerable pressure on interest rates. On examination it seems that the Commonwealth

(7) H. P. BROWN, *The Basic Wage Case 1952-53* (A statement made to the Commonwealth Court of Conciliation and Arbitration). Table XXIII.

(8) It is, of course, possible that capital inflows, by raising reserves, will encourage the relaxation of import controls. Thus they might exert, via increases in imports, a deflationary effect upon income.

COMMONWEALTH BANK:
CENTRAL BANKING DIVISION
(A£ mns.)

TABLE I

	June 1948	June 1949	June 1950
Notes	196.6	212.8	231.3
Deposits			
- Special	294.5	367.5	440.0
- Other Trading Banks	28.2	20.7	30.8
- Others (1)	176.0	186.4	222.4
Gold and Foreign Exchange	255.3	390.9	533.3
Securities (2)	396.8	339.3	330.6

(1) Including provision for contingencies.

(2) Including Treasury Bills.

Source: Annual Report, Commonwealth Bank.

Bank was content to exert a more modest restrictionary influence on the money supply, to persist in its use of qualitative controls over advances as a means of restraining bank lending to the private sector of the economy, and to maintain untouched the pattern of interest rates which had emerged in 1946-47.

In theory, it should be a fairly simple matter to assess statistically the steps taken by

Australian banking statistics render it very difficult. Some indications, however, can be obtained from the balance sheet of the central banking division of the Commonwealth Bank. This is set out in Table I.

This table suggests that in 1948-49 the central bank employed the Special Account procedure to sterilise some £A73 millions of the increase in bank reserves and further reduced the impact of the favourable balance on the commercial banks by reducing its government security holdings by £A58 millions. These two factors, together with the increase in notes in the hands of the public, must have offset the great part of the increase in overseas reserves. As against this, however, central bank loans to the commercial banks rose by £A15 millions.

In 1949-50, the Special Account device again absorbed £A73 millions. However, the decline in the central bank's domestic assets was trivial while central bank loans rose by £A11 millions. Clearly monetary policy was less restrictive in this year.

Table II sets out the principal liabilities and assets of the main Australian trading banks.

PRIVATE TRADING BANKS: MAIN ASSETS AND LIABILITIES
(A£ mns.)

TABLE II

	D e p o s i t s			Balance due to other Banks (1)	Cash	Cash Securities		Advances	Special Accounts
	Demand	Time	Total			Treasury Bills	Other Government		
June 1948	511.4	200.6	712.0	21.8	46.4	24.9	59.2	344.1	287.2
Dec. 1948	554.1	212.7	766.8	24.0	50.8	28.6	60.1	372.1	288.5
June 1949	606.9	217.3	824.2	36.7	43.1	14.1	63.3	377.5	383.1
Dec. 1949	648.5	218.4	866.9	19.7	55.4	33.2	76.4	403.2	321.4
June 1950	770.0	237.7	1,007.7	47.3	50.7	24.4	95.9	418.4	456.1
Sept. 1950	749.4	244.3	993.7	44.6	53.5	18.9	96.1	444.6	440.1
Dec. 1950	843.8	248.9	1,092.7	50.9	58.7	33.0	82.7	472.2	474.6
Mar. 1951	962.2	247.7	1,209.9	50.5	65.4	46.8	90.0	493.9	516.5
June 1951	1,026.5	250.2	1,276.7	55.0	59.7	43.5	91.6	502.4	568.1
Sept. 1951	941.1	249.6	1,190.7	61.8	53.4	31.6	82.7	545.6	526.3
Dec. 1951	957.8	241.0	1,198.8	67.6	61.3	25.2	64.9	610.5	498.2
Mar. 1952	992.3	236.2	1,228.5	62.7	65.7	34.2	62.5	651.4	461.4
June 1952	962.3	226.3	1,188.6	54.5	60.1	38.1	63.2	677.4	380.5

(1) Including loans from the Central Bank.

Source: Quarterly Summary of Australian Statistics.

the Commonwealth Bank to exercise quantitative control. In practice, the obscurities of

In both years there was considerable trading bank expansion. In 1948-49, for example,

the growth in demand deposits added £A95 million to the money supply. Most of this expansion, however, was due to the growth in Special Accounts. Net credit creation for the private sector amounted to only £A16 millions. It was financed partly by central bank loans. Lending to the government was reduced (9).

£A43 millions. Thus the outcome of the Commonwealth Bank's monetary policy was to add some £A121 millions to the money supply in 1948-49 and £A183 millions in 1949-50. From a rather formal point of view therefore it offset some part of the primary change in the earlier year while in the second it was content to prevent a secondary expansion.

INTEREST RATES (1) AND SECURITY PRICES: JUNE 1948 - JUNE 1952

TABLE III

	Time Deposits				Commonwealth Savings Bank (2)	Treasury Bills	Government securities		Shares Price Indices	
	3 months	6 months	12 months	24 months			Short	Long	Preference	Equities
	%	%	%	%	%	%	%	%		
1948										
June . . .	0.5	0.75	1.00	1.50	2.00	1.00	2.34	3.15	117	148
September .	0.5	0.75	1.00	1.50	2.00	1.00	2.13	3.13	118	146
December . .	0.5	0.75	1.00	1.50	2.00	1.00	2.13	3.13	119	148
1949										
March . . .	0.5	0.75	1.00	1.50	2.00	1.00	2.06	3.13	116	141
June . . .	0.5	0.75	1.00	1.50	2.00	0.75	1.99	3.11	114	139
September .	0.5	0.75	1.00	1.50	2.00	0.75	1.99	3.14	111	139
December . .	0.5	0.75	1.00	1.50	2.00	0.75	1.97	3.13	112	150
1950										
March . . .	0.5	0.75	1.00	1.50	2.00	0.75	1.95	3.13	112	158
June . . .	0.5	0.75	1.00	1.50	2.00	0.75	1.95	3.15	112	162
September .	0.5	0.75	1.00	2.50	2.00	0.75	1.97	3.15	111	169
December . .	0.5	0.75	1.00	1.50	2.00	0.75	2.00	3.17	112	185
1951										
March . . .	0.5	0.75	1.00	1.50	2.00	0.75	2.02	3.27	111	193
June . . .	0.5	0.75	1.00	1.50	2.00	0.75	2.05	3.51	110	202
September .	0.5	0.75	1.00	1.50	2.00	0.75	2.04	3.83	106	184
December . .	0.5	0.75	1.00	1.50	2.00	0.75	1.99	3.75	101	166
1952										
March . . .	0.5	0.75	1.00	1.50	2.00	0.75	2.00	3.81	97	150
June . . .	0.5	0.75	1.00	1.50	2.00	0.75	2.21	4.62	92	142

(1) Maximum interest rates on time deposits and savings bank deposits were fixed by the Commonwealth Bank under the National Security (Economic Organisation) Regulations until 1952. The maximum rates on these were unchanged after November 1945.

(2) On first £A500 only.

Sources: Finance Bulletins, 1947-48 to 1949-50. Statistical Bulletins, Commonwealth Bank.

In 1949-50, the contribution of the Special Account device was far more modest — accounting for less than half the expansion in demand deposits. Net credit creation for the benefit of the private sector was, however, still relatively small at £A21 millions. Indeed, the main expansionary factor was increased lending to government which accounted for

the expansion. It is perhaps worth noting that the ratio of the money supply to gross national expenditure, a crude index of « liquidity », was constant.

We can supplement this crude index of liquidity by examining the behaviour of the principal interest rates since these can be regarded as rough indices of the availability of funds through the capital market. Examination of Table III shows that there were only two developments of any importance.

(9) Treasury Bills were repaid from each surplus of the Commonwealth as follows: 1948-49 £A84 millions, 1949-50 £A15 millions.

First, there was a recovery in the prices of short-term government securities from the rather low levels produced by the banking sales of 1947-48. Second, after September, 1949, a boom in equities developed.

In studying this table we may regard the steadiness of the « administered » rates as reflecting the official desire to maintain cheap money. What is the explanation of the boom in equities? Two general influences were probably at work. First, Australia's continuing inflation may have increased the public's preference for equity holdings. Second, the persistently favourable balance of payments together with the rise in export prices may well have generated a feeling of confidence. It is, of course, also possible that some of the inflow of capital passed into the stock market.

There is no direct evidence to suggest that « switching », either by financial institutions or individuals, was of much importance in 1949-50. Life Assurance offices were net sellers of government securities in the year but sales were small while their purchases of equities were negligible. It is possible that individuals, like life offices, devoted the greater part of their savings to increasing their holdings of assets other than government securities but attempts to trace the flow of savings have produced no worthwhile statistical results. New issues on the equity market were only slightly higher in 1949-50 than in 1948-49 — £A39.1 millions against £A38.6 millions.

An estimate, necessarily tentative, would suggest that the main reason for the equity boom is to be found in the optimism engendered by the rise in export prices and the continuing strength of the balance of payments. The equity boom was, indeed, one aspect of the inflationary danger arising out of the favourable balance. For its continuance, after the removal of capital issues control, could hardly fail to encourage new issues and hence stimulate domestic investment, while the capital gains being made by equity holders may have encouraged consumption. Moreover, if « switching » were to develop on any scale, as it might well do if the stock market boom persisted, the central bank could be faced with a buoyant market for new issues coupled with falling bond prices. Thus, despite the measure

of success enjoyed by the central bank in its manipulation of the money supply, the economy at the end of 1950 was exposed to the potential dangers of inappropriately easy finance through the new issue market with its necessarily inflationary consequences and threat to the maintenance of cheap money for the Commonwealth.

4. - 1950-1951: The Wool Boom.

In 1950-51 the balance of payments was again heavily in surplus and Australia's external resources rose by £A193 millions. The impact of the balance of payments on the economy was, however, very different from that of 1948-1950.

The surplus of 1950-51 did not originate, as the two earlier surpluses had largely done, in private capital inflows. In fact the capital inflow on private account declined from £A266 to £A110 millions. This decline, however, was more than offset by the sharp rise in wool prices which raised the value of wool exports from £A313 millions to £A633 millions and accounted for the major part of the rise in export proceeds from £A594 to £A975 millions. This important change, though partly offset by a rise in imports, had a direct impact upon incomes. Farm incomes in fact rose from £A548 millions to £A888 millions. Once again, in so far as it aimed at domestic stabilization, the Commonwealth Bank could follow either of two policies. The first of these was to pursue the limited objective of preventing financial factors from aggravating the inflationary pressure originating in the balance of payments. The second possibility was to use monetary policy in a more positive way and attempt to exert a deflationary influence through the curtailment of domestic consumption and investment. Since the main anti-inflationary device available, fiscal policy, could not, apart from its automatic aspects, exert any immediate pressure, it could be argued that there was a real need for monetary control of the more ambitious kind. We shall now examine the policy actually followed by the Commonwealth

Bank. Table IV gives the position of the central banking division at the beginning and end of the financial year.

TABLE IV
COMMONWEALTH BANK:
CENTRAL BANKING DIVISION
(£ millions)

	June 1950	June 1951	June 1952
Notes	231.3	275.2	301.7
<i>Deposits</i>			
— Special	440.0	552.3	244.2
— Other Trading Bank	30.8	29.0	45.2
— Other (1)	222.4	283.9	281.9
Other Liabilities	—	15.4	19.3
Gold and Foreign Exchange	533.3	714.5	296.7
<i>Securities</i>			
— Commonwealth	261.4	256.0	421.9
— Other	69.2	94.1	59.9
Cash Assets	14.1	9.8	23.1
Other Assets	61.3	80.5	90.6
Total Assets	939.5	1,155.8	892.4

(1) Includes contingencies.

Sources: Annual Report, Commonwealth Bank.

This table shows that, of the £A181 millions increase in external assets as shown on the balance sheet, the Commonwealth Bank made use of the Special Account device to sterilise some £A112 millions. Since the public's holdings of notes increased by £A37 millions, roughly £A150 millions of the rise in external assets is accounted for by these two items while a further £A6 millions may be regarded as absorbed by the net increases in the commercial banks' holdings of notes and deposits. Looked at in this way it seems that central banking policy was strongly restrictive.

On the other hand it is clear that the Bank's domestic assets increased by £A35 millions. This sum, however, was less than the increase in «other deposits» — an item which decreases commercial banking resources (10). This suggests that a mere evaluation of the Special Account call in relation to the aggregate expansion of central bank assets understates the degree of restraint imposed

(10) The rise of «other deposits» involves a change in the composition of central bank liabilities in such a way as to reduce trading bank deposits.

upon the commercial banking system. Moreover, the Commonwealth Bank intensified its qualitative controls in November 1950 and thus imposed a further restraining influence. It seems clear, however, that the Bank was pursuing the less ambitious of the two possible policies we have enumerated.

Despite the small increase in their cash resources permitted by the central bank, the trading banks engaged in a major expansion.

Trading bank demand deposits rose by £A257 millions. This, together with the increase in the demand deposits of other cheque paying banks and the £A37 million expansion of the public's note holdings, increased the money supply by £A340 millions.

This expansion in demand deposits resulted from an increase in Special Accounts and cash amounting to £A121 millions. Since advances from the central bank roughly financed the rise in cash, the secondary expansion by trading banks was approximately £A140 millions. Of this £A72 millions was on account of net credit creation in favour of the private sector and £A19 millions on account of additional lending to the government on Treasury Bills. The total expansion in the money supply was £A340 millions. Despite this growth the ratio of money supply to gross national expenditure declined slightly.

It would be a mistake to regard this secondary expansion by the commercial banks as an actively inflationary factor. Much of the increase must, in fact, have been made necessary by the rising prices of exports and it was certainly the intention of the Commonwealth Bank to confine the growth of advances to such legitimate short-term working needs. There were, however, other inflationary financial factors at work and their importance must not be obscured by excessive concentration on the performance of the banking system.

Once again we show in tabular form the behaviour of the main interest rates and security prices (Table III).

The «administered» group of rates which reflect the authorities' intention remained unchanged. After January 1951, however, an increasing weakness developed in the market for long-term securities. The first hint of

trouble came in December 1950 when a 3¹/₈% conversion offer to holders of £A129 millions of 4% stock was accepted only to the extent of £A100 millions. In April 1951 the £A40 millions Twelfth Security Loan was issued at an effective yield of 3¹/₄%, the authorities thus acquiescing in the rise in rates. This loan was successful, but security prices continued to fall and by the end of June yields were fractionally above 3¹/₂%. Cheap money was plainly crumbling under pressure. At the same time, however, as government was finding money dearer and less readily available the private sector was finding the reverse, for as bond prices fell, share prices rose and the new issue market enjoyed a major boom. New money raised on the capital market by private enterprises in 1950-51 amounted to £A78.8 millions — over twice the figure for the two earlier years. This contrast is highly suggestive. Nevertheless, as we shall see, it understates the change in the availability of finance to the private sector.

Part of the explanation of the weakness in security prices is to be found in the behaviour of the main institutional investors. Saving bank deposits rose in 1950-51 by £A76 millions. Of this sum £A45 millions went into government securities, £A44 millions of it from the Commonwealth Savings Bank. The State Savings Banks placed their funds in semi-government securities (£A16 millions) and loans on mortgage (£A4 millions). Savings Banks, however, have rather rigid portfolio policies. A more spectacular redistribution of resources was undertaken by life assurance offices.

The increase in life assurance assets in Australia in 1950-51 was £A41 millions. None of this sum went into Commonwealth securities. Indeed the life offices ran down their holdings of Commonwealth securities by £A15 millions either by refusing conversion or by sales upon the market (11). Of the £A56 millions thus made available, £A37 millions was lent directly to the private sector while increased holdings of debentures, preference shares, and equities absorbed £A9 millions. The remaining £A10 millions was used to

(11) It is not possible to estimate these items separately.

purchase semi-governments. Thus the security market was not only denied its customary support from the life offices' new investment but was also exposed to the unpleasant consequences of their energetic «switching».

We may now summarise the principal institutional sources of additional finance to the private sector as follows:

	1950-51 £A mills.	1949-50 £A mills.
<i>Lent Directly:</i>		
Net bank credit	72	21
Life Assurance & Savings Banks	41	30
<i>Lent via the Capital Market: new issues of:</i>		
Ordinary Shares	66	29
Preference Shares	5	4
Debentures	8	6
Total Market	79	39

This summary suggests that the problem of limiting the role of the financial system in encouraging inflation through greater availability of finance to the private sector cannot be regarded merely as a matter of restraining the banking system. Banking behaviour is, undoubtedly, a major determinant of the ease with which the private sector may obtain finance but it is clear that monetary policy, to be effective, must also aim at influencing conditions in the new issue market and the decisions of financial institutions other than banks.

5. - 1951-1952: The Liquidity Crisis.

The magnitude of the monetary problems involved in economic dependence was underlined for Australia in 1951-52. In this year the balance of payments, which in each of the three previous years had made possible an increase in external assets of between £A180-£A200 millions, became heavily adverse. The fall in reserves was, in fact, some £A464 millions (12).

(12) There are various figures given for the change in external reserves. That quoted is the figure given by the

The reasons for the dramatic change are not hard to seek. The main cause was the fall in export earnings due, as is well known, to the collapse of wool prices. The value of wool exports fell from £A633 millions to £A324 millions. Import prices rose somewhat and the terms of trade index fell from 184 to 119. Moreover, the position was complicated by the lagged response of imports to the boom income levels of 1950-51 and the existence of a stock cycle in imported commodities (13). The balance of trade moved from a surplus of £A233 millions in 1950-51 to a deficit of

the International Bank amounting to £A25 millions. Nevertheless, despite the relative stability of « autonomous » items on the capital account, the crisis was plainly of the utmost severity requiring a rapid and well-timed reversal of policy on the part of the central bank. It is to central banking action which we now turn. However, since our discussion of the general economic background is of necessity so brief, we include, in Table V, a summary of the movements in the more revealing economic indices and aggregates.

MAIN ECONOMIC INDICATORS AS AT JUNE 1951 AND 1952

TABLE V

Date	Unemployment							Ratio of Money Supply to Gross National Product (d)
	% of T. U. Members unemployed	Persons on Benefit	Retail Prices (a)	Average Earnings (Male) (£ A per week)	Gross (b) National Product (£ A m.)	Farm (c) Incomes (£ A m.)	Money Supply (£ A m.)	
	(1) %	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1951 June	0.8	733	1.833	12.34	3,633	780	1,247	0.34
1952 June	2.2	5,145	2.206	14.46	3,855	451	1,347	0.35

Sources: Cols. (1) to (4): Quarterly Summary of Australian Statistics. Cols. (5) and (6): National Income White Paper. Cols. (7): Quarterly Summary of Australian Statistics.

Notes: (a) « C » Series index. (b) Totals for 1950-51 and 1951-52. (c) Figures for 1950-51 and 1951-52 in Table I of Appendix to National Income White Paper. (d) Calculated from figures in Cols. (5) and (7).

£A390 millions in 1951-52; a total swing of £A623.

Contrary to what might have been feared or even expected, there was no outflow of capital. Private capital inflows remained at the same level as 1950-51 (14) and the situation was somewhat improved by a loan from

The main problem facing the Commonwealth Bank in this year of crisis was to maintain the liquidity of the commercial banking system. A fall in external assets of £A460 millions exerts an equivalent contractionary influence on commercial bank reserves. Hence the central bank was required to act as a lender of last resort on an enormous scale if a banking crisis was to be avoided. Moreover, the task facing the central bank was complicated by the speed with which the crisis developed for the year 1950-1951 had ended with the central bank actively attempting to restrain inflation by use of its qualitative and quantitative controls and the crisis year itself began with inflationary pres-

Commonwealth Bank *Annual Report* (1951-52) and the Commonwealth Statistician, *Australian Balance of Payments, 1951-52, 1952-53 and first half 1953-54.*

(13) The investment in stocks in 1951-52 was £A401 millions compared with £A246 millions in 1950-51. Cf. on this point H. P. Brown, *op. cit.*, pp. 55-59.

(14) Statistical estimates of this item lead to some difficulties of interpretation. It seems, however, that although the speculative inflow ceased after June 1950 there was no repatriation.

sure still the main problem (15). A disinflationary budget had also been introduced while capital issues control had been reimposed in February 1951. The difficulties occasioned by the lagged response of imports were thus, to some extent, intensified by the lagged response of fiscal policy (16) and government administrative decisions. The balance sheet of the central banking division shows how the Commonwealth Bank met the challenge of this sudden and severe reversal of economic fortune.

The decline in external assets shown in this table amounts to £A418 millions. Total assets, however, fell by only £A263 millions. Hence there was plainly some offsetting (17). We shall discuss this aspect of matters later when we examine the behaviour of security prices.

Since total assets declined by £A263 millions while notes with the public increased by £A26.5 millions the aggregate pressure on bank reserves was of an order of £A290 millions. This was more than offset by the reduction of £A308 millions in Special Account Deposits. In fact, the free balances of the trading banks rose by £A16 millions. Technically, therefore, the Commonwealth Bank met the liquidity problem by expanding domestic assets, including loans to the trading banks, and allowing large-scale releases from Special Accounts. The technical simplicity of both steps should not be allowed to obscure the skill and smoothness with which the central bank sustained the liquidity of the commercial banks.

The statistical reflection of the Commonwealth Bank's operations is to be seen in outline in Table II which displays the quarterly positions of the trading banks.

In the face of a liquidity crisis of extreme ferocity, the decline in demand deposits was £A64 millions and in time deposits £A24 millions. In the earlier, and more severe,

(15) Commonwealth Bank, *Annual Report* (1951-52), p. 7.

(16) The government's reaction to the wool boom was to:

(a) aim at a surplus of £A114 millions in 1951-52;

(b) introduce a special levy on wool prices;

(c) reintroduce capital issues control.

Import controls were imposed in March 1952.

(17) Cf. Commonwealth Bank, *Annual Report* (1951-52), p. 24.

period of strain, central bank loans were expanded by some £A12 millions. Over the year the banks sold, no doubt largely to the central bank, some £A39 millions of securities. This change, together with the £A288 releases from Special Accounts, enabled the banks to finance the £A175 million expansion in advances. And this, in its turn, allowed Australian importers to meet their obligations and finance the large-scale, and largely unplanned, increases in their stocks of imported goods (18).

The second statistical reflection of the change in the Australian economic climate as it influenced the availability of finance is provided by the movements in interest rates and security prices. These are set out in Table III.

It is clear from this table that the liquidity crisis not only eliminated cheap money but also brought about a collapse in the equity market. The steadiness of the administered group of rates reflects the fact that the authorities parted with cheap money unwillingly. We may now examine the interest problem a little further.

In order to get a clear picture of events in the security market we have to examine first of all the portfolio decisions of investing groups. Later we can examine the impact of governmental finance.

We have already noted that the trading banks were net sellers of securities in 1950-52. The statistical survey published by the Commonwealth Bank shows net banking sales of marketable securities other than Treasury Bills as £A28 millions. Life offices reduced their holdings by a further £A11 millions. These pressures were re-inforced by a fall in the private sector's portfolio which amounted to £A35 millions. The Commonwealth Savings Bank and Trading Bank taken together reduced their holdings by some £A2 million. From the magnitude of these movements we may infer that the central bank was faced either with the immediate abandonment of

(18) Not all this finance was required by importers. Moreover, since the rise in stocks was £A400 millions it is clear that the banks did not provide even half the necessary finance. Other expedients by enterprises included reduction in dividends and postponement of investment in fixed capital.

cheap money or a large scale monetisation of the national debt.

The Commonwealth Bank in its central banking capacity stated that «it purchased government securities on the market on a much heavier scale than in recent years» (19). Total purchases were, indeed, of the order of £A108 millions. There could, however, be no very sustained defence of cheap money. First, rates had already been allowed to slide in the previous year. Second, the scale of selling was too great for a successful holding operation. All that the bank could do was to offer some support designed partly to maintain bank liquidity and partly to prevent demoralization of the market.

In this type of situation government borrowing was certain to run into difficulties. The total borrowing approved for the year was £A225 millions. Public loan raisings provided only £A64 millions. The gap of £A160 millions was filled by the surplus of Commonwealth revenue over expenditure other than loan expenditure (£A98 millions), use of the counterpart funds arising from the £A25 millions loan from the International Bank, and £A45 millions of central bank credit.

The difficulties confronting government also confronted private borrowers. New issues by private borrowers fell from £A79 millions in 1950-51 to £A47 millions in 1951-52 (20). No doubt the fall partly reflected the reimposition of capital issues control but new issues must have looked substantially less attractive on a falling market — a circumstance which can only have increased the dependence of enterprise on the banking system.

Surveying the experience of the government and private borrowers and taking into account the massive support to the market provided by the central bank (21) it is difficult to escape the conclusion that the crisis was complicated by a sharp increase in liquidity preference. The climate in which the central bank was called upon to operate could thus scarcely have been less pleasing. Though the

money supply was broadly stabilised and the ratio of money supply to gross national expenditure was approximately constant as between 1950-51 and 1951-52 (22), there was a sharp rise in rates on marketable securities and a collapse of stock prices. This cannot be explained by «switching» between financial assets but only by a general movement out of financial assets into money — in other words an increase in «bearishness» or liquidity preference. This factor operated to render still less comfortable a situation already made difficult enough by the collapse of export incomes, the large inflow of imports, and the weakness of the security market.

6. - Some Reflections on Australian Experience.

The task of the Commonwealth Bank may be defined as manipulating the cost and availability of money in such a way as to promote stabilization (23). How well was this task performed? Let us look first at the «surplus» years — 1948 to 1951.

In general there can, I believe, be little doubt that over this period the Commonwealth Bank was successful in preventing any large secondary expansions of the money supply and keeping net bank credit creation for the private sector within reasonable bounds. In achieving these objects the Special Account device proved well adapted to Australian requirements (24) and, while it has been asserted that qualitative controls over advances tends to leak and that too much reliance was placed upon these controls, there is little evidence that leaks were of major importance (25). It seems therefore that such criticisms as can be made do not relate to the Commonwealth Bank's control of the banking system but to its neglect of some additional

(22) Cf. Table V above.

(23) As defined in Section 2 above.

(24) For a similar view cf. R. R. Hirst, *Post-War Monetary Policy in Australia*, «Economic Record», Vol. XXIX, No. 56, pp. 1-18.

(25) This view appears to be derived from the fact that the decentralised administration of advances controls by the leading banks whose interests lay in increasing advances led to excessively lenient interpretations of the central bank's directives.

possibilities of *general* financial control in 1950-51.

There are three important external sources of finance for private investment: bank credit creation, loans from financial institutions such as life offices, and sale of securities upon the capital market. Of these the central bank has a direct influence only upon the first. Is this limitation important? Let us look at the boom years of 1950-51 a little more closely.

Gross private investment in 1950-51 was £A696 millions. Depreciation allowances and undistributed profits provided some £A400 millions of «automatic» finance; capital transfers by public authorities a further £A62 millions. Hence some £230 millions had to be obtained from the sources listed. These provided finance roughly as follows:

	£Am.
Bank Advances: (gross)	84 (net £A72 millions)
Life offices and Savings Banks	41
New Issues	79

It thus seems that non-bank sources, even in a year in which the expansion in bank advances was particularly heavy, were of considerable importance (26).

A further factor influencing investment is trade credit. If this is defined to include inter enterprise credit alone is not a source of finance in the same sense as the remaining three since it does not increase the purchasing power of enterprises as a whole save in so far as it activates existing idle balances. Nevertheless, its ready availability will influence the investment decisions of enterprises through their liquidity position. A rough estimate suggests that trade credit expanded very greatly in 1950-51. This ready availability must have increased the readiness to invest (27).

(26) The increase in new issues over 1949-50 at £A40 millions was only slightly less than the increase in the gross addition to advances at £A43 million.

(27) Where some enterprises are granting more credit than they receive the consequence is similar to the activation of idle balances via the capital market. In this case the enterprises concerned are behaving as financial intermediaries. In practice, Dr. Hall's survey (*op. cit.*) suggests that, for most industrial groups, trade debtors and creditors grew equally. In this event it is easier to think of the readier availability of trade credit as decreasing the need for liquidity.

It is clear from this that there were further possibilities of influencing private investment through reducing the availability of finance from non-bank financial institutions and the capital market as well as by restraining the expansive influences of trade credit.

The availability of finance through the capital market depends fundamentally on the state of confidence. In Australia, it seems clear that this elusive variable is intimately connected with wool prices. Rising wool prices encourage rising equity prices. These make new issues easy and give an additional fillip to business confidence. As a consequence trade credit becomes easier to obtain with the result that liquidity considerations recede in importance and investment looks additionally attractive. If this account of matters is broadly accurate it seems that beneficial results might be obtained through modifying conditions in the capital market: that is by reducing the availability of new money.

One possibility is immediately obvious — the imposition of capital issues control. For most of the boom year, however, this control was in abeyance (28). This did not eliminate all the possibilities of official action for, insofar as the buoyancy of the new issue market was sustained by «switching» out of government securities (29), the central bank might still have been able to influence events. To do so, however, would have involved the open abandonment of cheap money, a move which was probably unacceptable to the Treasurer. Hence, though it would be somewhat unfair to criticise the Commonwealth Bank for failing to carry out such a policy, it seems reasonable to suggest that the open abandonment of cheap money and a sharp rise in the rates on long term securities *brought about at official initiative* might not only have reduced «switching» by imposing capital losses on the «switchers» but also have diminished both the general optimism of business and the availability of funds through the capital market.

(28) It was unfortunate that the removal of this control coincided with the wool boom. Political considerations may, however, have dictated the decision.

(29) It is, of course, impossible to determine the extent of «switching» within the group composed of non-financial enterprises and individuals since in the available statistics all such «switching» is concealed by the aggregation process.

(19) *Ibid.*, p. 24, cf. also the reference (*ibid.*, p. 20) to «strong efforts by the Central Bank to support the market».

(20) A. R. HALL, *op. cit.*

(21) Whether this support was directly undertaken in order to maintain interest rates is a question of importance in some contexts but not in this.

et. These two consequences, had they resulted, would probably, in their turn, have restrained the expansion of trade credit in 1950-51 and might have reduced the stampede out of securities and into money which developed in 1951-52.

It would be wrong to press this argument too far — not only because it is based upon hindsight but more importantly because the close connection between security prices and conditions in the new issue market found for example in the U.S.A. (30) is not present to the same degree in Australia (31). Nevertheless, if criticism can be levelled at the conduct of the Commonwealth Bank during 1948-51 at all, it must, I believe, rest mainly on the argument that it was unwise to leave the initiative with the market and allow interest rates to climb unsteadily upwards in the face of official resistance. This view is strengthened rather than weakened by the consideration that, as a consequence of war finance, security portfolios were unusually large — a circumstance which encouraged « switching » (32).

The Commonwealth Bank's handling of the « liquidity crisis » of 1951-52 is not open to any serious criticism. Indeed, the smoothness with which this crisis was surmounted is in itself an eloquent testimonial (33). It is true that the Bank's attempt to stabilise security prices had to be abandoned and interest rates allowed to rise — a difficulty which might have been avoided if a more active interest policy had been adopted in 1950-51. But beyond this there is little which can be

(30) This close connection is, I believe, fundamental to the technique of market manipulation advocated by Allan Sproul and R. V. Rosa. Cf. essays by those authorities in *Money, Trade and Economic Growth* (New York, 1951).

(31) Cf. the behaviour of interest rates and equity prices in 1950-51. Australian enterprises' relative dislike of debenture finance is an important factor in this connection.

(32) « Switching » was, of course, relevant to other problems than the equity boom. The expansion of life office loans on policies etc. (£441 millions in 1950-51) was, as we have seen, partly financed in this way. It is interesting, moreover, to note that the life offices explained their security sales by a desire to reduce security holdings to more « normal » proportions.

(33) Cf. R. R. Hirst, *op. cit.* This is an important matter since attempts at domestic stabilization in the face of export fluctuations clearly involve wide fluctuations in external reserves and hence in commercial bank cash.

said in criticism while much could be said in appreciation. The Special Account device proved capable of dealing effectively with sudden reverses of fortune and must be regarded as a central banking technique particularly well adapted to Australian conditions.

Australia's experience in 1948-52 not only illustrates the type of monetary problem to which dependent economies are unavoidably exposed but demonstrates beyond dispute that a properly equipped and wisely managed central bank can play an important part in meeting them. Certainly it is very difficult, in the light of past events, to believe that these problems would have been as readily surmounted by a banking system lacking central bank leadership and control. A second and scarcely less obvious conclusion is that the « traditional » central banking techniques are ill adapted to the needs of a dependent economy experiencing major fluctuations in external reserves.

A somewhat less platitudinous conclusion to which events in Australia lend support is that, given a favourable economic structure and the extent of financial development, the greater the degree of dependence the greater the scope for monetary policy and the greater the need for effective central banking. The reason for this is very simple. The economic climate in dependent economies can, and does, change with disconcerting suddenness. Fiscal policy though theoretically the more powerful and certain stabilization device is (like all heavy artillery) difficult to deploy quickly. Central banking control on the other hand is tactically agile. « Flexible » is a word which recent discussions of monetary policy have all but emptied of any but emotional significance. Nevertheless, in the sense of being readily reversible in direction and capable of rapidly changing emphases on credit allocation, central banking policy is certainly flexible. And flexibility, cyclical as well as seasonal (34) is

(34) The problem of seasonal flexibility which is of considerable significance in Australia has been neglected largely for reasons of space. R. R. Hirst (*op. cit.*) has some discussion of it. In years in which deposits are, on average, constant seasonal problems are probably best met by allowing offsetting fluctuations in its banks' liquid assets ratios. This leaves the central bank free to concentrate on cyclical questions.

clearly a major requirement in dependent economies. This is not to say that full reliance can be placed upon monetary policy. Rather monetary policy plus import (35) controls should be looked upon to provide the first line of defence, their essential function being to give the necessary time for fiscal and other adjustments to be planned, debated, and im-

(35) And perhaps capital issues control?

posed. Finally, monetary policy needs to pursue its limited objectives on a wide front. This is so not only because bank finance is technically rather easily controlled but also because the capital market is likely to display considerable elasticity in export booms and is, quantitatively, of comparable significance.

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