ECONOMIC GROWTH

AND

MONETARY STABILITY

Lectures delivered by

CE FRERE and RODRIGO GOMEZ

9 November 1964

Basle, Switzerland

under the sponsorship of

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FOREWORD

Shortly after the death of Per Jacobsson in May 1963, his friends sought to find an appropriate means of carrying forward the unique contribution which this great man had made to the world. Their thinking soon focused on the idea of creating a Foundation, bearing his name, which would sponsor lectures and publications in the field of international monetary cooperation.

With the strong support of a group of 45 distinguished sponsors, The Per Jacobsson Foundation was incorporated in February 1964, and a widespread group of Per Jacobsson's friends and admirers joined in providing the necessary funds.

The first lectures given under the aegis of the Foundation were delivered at 3 p.m. on November 9th, 1964, in the Aula der Universität, Basle, Switzerland. The principal speakers were Maurice Frère, of Belgium, and Rodrigo Gómez, of Mexico. Their subject was "Economic Growth and Monetary Stability." Opening statements were made by the Rector-Designatus of the University of Basle, Professor Wolf-Heidegger, and by Ambassador W. Randolph Burgess, President of the Foundation. Professor Wolf-Heidegger and Mr. Frère spoke in French; Ambassador Burgess and Mr. Gómez spoke in English.

The proceedings of the first meeting are being issued in English, French and Spanish. Requests for extra copies should be addressed to the Secretary of the Foundation, at the address shown below.

THE PER JACOBSSON FOUNDATION

International Monetary Fund Building—19th and H Streets N.W.

Washington, D. C. 20431 U.S.A.

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OPENING REMARKS

by

PROFESSOR DR. GERHARD WOLF-HEIDEGGER

Rector-designatus, University of Basle

Mr. President, Mr. Counselor of State, Ladies and Gentlemen:

IT is a great honor for the Rector of the University of Basel to introduce the inaugural lecture of a foundation created to perpetuate the unforgettable memory of Per Jacobsson. Unfortunately Rector of the University Professor Max Imboden was called to Berne to attend a meeting of very great importance for the Swiss universities. He is extremely sorry not to be with us, and has asked me to offer you his apologies. However, Professor Imboden left me a written text of what he intended to say, and has entrusted me with the task of conveying to you his respects and his introductory remarks. I am all the happier to do so because I also count myself among those who deeply appreciated that great scholar and remarkable man, Per Jacobsson.

The jurist, Imboden, has links with your field of interest through public and commercial law. In me you will have to make shift with an anatomist, who is interested in a normal economy merely as a private person and as a citizen. However, a cartoon that appeared in 1954 in the *American Scientist* gives me the courage to address you. The satirical drawing by the famous American caricaturist, Bernarda Bryson, shows that between your field and mine there even exists a relationship that one might not suspect at first sight. In this cartoon a post-mortem examination is being carried out on the corpse of the "economic man" by the "fathers of economics," including, among others, Adam Smith, Thomas Mathus, John Stuart Mill, Francois Marie Charles Fourier, Auguste Comte, and Karl Marx. Alas, they had not been able to cure the patient.

However, on the basis of the findings at the post-mortem examination, they discuss the reason for his death in order to draw lessons from it for the future.

Per Jacobsson's whole inclination and all his efforts were to prevent this cartoon of Bernarda Bryson's from ever becoming a reality again.

And now, may I read you Rector Imboden's address?

In his book entitled "An Inquiry into the Nature and Causes of the Wealth of Nations" Adam Smith assigned a dual role to political economy: the exact observation of human behavior, and the recognition of general laws governing the effects of economic actions. Thus economics, more than any other science, is exposed to the contrasting influences of these two opposite methods. Primarily, the science of economics is a humane science. It seeks to record and isolate the significance of the human factor as it is brought out by intangible stimuli or, in other words, by the course of history. Insofar, however, as it seeks to demonstrate the immediate or long-term consequences of economic actions, it approaches the natural sciences. It asks questions about causes and effects and seeks in its answers to formulate universal laws.

In the course of the twentieth century, the field of human knowledge has undergone a greater expansion than at any other time in history. Every day the natural sciences, in their many and varied forms, are enriched by new conquests. Our knowledge, the sum of our learning, is enlarging to such an extent that it is becoming almost incommensurable. But, at the same time, new dimensions are unfolding to our mind and to abstract research. Only our knowledge of man seems to remain more or less dependent on traditional methods. But even in this sphere we have witnessed revolutionary changes. Man has found the means to cross the threshold of his ego, his conscious personality. Gradually, by illuminating the half-light of his psyche, he has succeeded in grasping the phenomena of the subconscious. As a result of the development of these fundamental principles and methods, the science of economics today, it seems, presents an entirely new appearance. At least there can be no argument about the fact that our knowledge has reached another high point. What we know about *homo economicus* and the laws governing every development, every economic change, is more extensive than ever, even though the science of economics is marked, and will no doubt continue to be marked, by a contrast arising from the fact that it devotes itself at one and the same time to the study of man and of the laws of causation.

It would therefore appear that he who wishes to gain a thorough knowledge of economics must simultaneously acquire mastery in two separate fields. He must be firmly grounded in the historical realities of his time; he must understand man as a being whose actions, in the final analysis, spring from imponderable motives. But he must also perceive, with the clarity of a mind free from all preconceived ideas, the causes and effects in the sequence of economic events and give credit to the relentlessness of economic laws. The economist lives in the concrete as well as in the abstract world; he is both a practical man and a man thirsting for pure knowledge.

He to whose memory we are today paying tribute, and whose work we mean to continue, was blessed with both these qualities. Growing in his solitude, and at the cost of unwearying endeavor, he mounted the road that, as no other, leads to the mastery of our epoch. Never before has mankind had at its disposal such immense opportunities for both good and evil. May we follow the example of Per Jacobsson, who, throughout the whole course of his full life, gave a new impetus to the forces of good.

INTRODUCTORY REMARKS

by

AMBASSADOR W. RANDOLPH BURGESS

President, The Per Jacobsson Foundation

Dr. Schaller, Professor Heidegger, Governors of the Bank for International Settlements, Ladies and Gentlemen:

FIRST, let me express my thanks to Professor Wolf-Heidegger and, through him, to the Rector, who couldn't be here today, but sent us such an interesting message; to Professor Bombach; to Dr. Veillon; and to all of those from the University who helped us by making available this beautiful hall and working with us in the preparation of this program.

Second, we extend our appreciation to the Bank for International Settlements for the tremendous help that they have given us from the beginning of this enterprise, and particularly to Mr. Ferras, Mr. d'Aroma and others of the Bank, who have done so much for us.

My next remark must be to express the pleasure all of us feel for the presence here of Mrs. Jacobsson and others of the Jacobsson family, participating in this occasion. We are particularly grateful to Mrs. Jacobsson for making available to us this beautiful portrait of Per which stands before you.

I also want to say how much all of us, among ourselves, appreciate the tremendous response that we have received from our sponsors, and our contributors, many of whom are here today. The list of those who have taken a share in this enterprise is a "Blue Book," a "Who's Who" of the financial world. A few figures will show you the scope of participation. Contributions were made by four international agencies and by six governmental agencies, including the City of Basle, which is a very generous participant. Forty-six central banks contributed, 181 private banks and corporations, and 182 individuals, making a total of 419 participants.

I have never taken part in a venture where there has been such a tremendously generous and enthusiastic response to our proposals. The reason is that this enterprise fulfills two sorts of dreams. The first dream, ever since we lost Per Jacobsson from our midst, has been to find a suitable memorial for him. We think that we have found it in this series of lectures that will be repeated, year by year, on the subjects to which he devoted his life.

Behind and beyond that, this undertaking of ours helps to fulfill certain dreams that all of us have long had of increased and closer international monetary cooperation. For me this dream goes back 40 years, when my chief at the Federal Reserve Bank of New York was Benjamin Strong. He conceived the idea that the central bankers ought to know each other and meet and work together. He started with Montague Norman, and they developed personal relationships with other central bankers.

A second step was the creation of the Financial Committee of the League of Nations, where financial people learned to work together. One of those people who was most effective was a young man named Per Jacobsson, along with Sir Arthur Salter, Maurice Frère, and Jean Monnet.

Third, there was the creation of the Bank for International Settlements, a by-product of the Young Plan of 1929, which far outgrew its origin by becoming a regular meeting place of central bankers for intimate consultation.

Then came the IMF—which has succeeded far beyond the dreams of most of us—and other developments such as the Group of Ten and Working Party No. III.

Now today we come together to fulfill another step in that dream with a quite new sort of project: to ask the very best people that we can find anywhere in the world to prepare careful statements of their experience and their beliefs, free from the handicap of official responsibilities. You will have noticed that, in our list of Sponsors and Directors, we have avoided close government connections, so that everybody may speak freely.

There are always two ways of investigating a question. One is to appoint a commission, which will reach a compromise; the other is to appoint an individual and let him give you his best, free, and untrammelled thought. That is what we are doing in this series of lectures, and our hope is that, as this series goes forward over the years, not only will we think time and time again of Per Jacobsson and his great ideals, but that people who are working in the field of international finance will find from these lectures help, encouragement, and inspiration.

We are here today at the commencement of a new and a great enterprise, that you here today, and others who couldn't come, have made possible. We hope that it will have its wider influence through the publication of the lectures.

* * * *

With those few words I propose to move forward and, without more ado, introduce the first speaker. I hardly need to introduce him, as he is well known to all of you and his full biography is given in the program. Our beloved friend, our very able friend, Maurice Frère.

LECTURE

by

MAURICE FRERE

President, Sofina; *Honorary Governor,* National Bank of Belgium

As I address you today, at the invitation of the Board of Directors of The Per Jacobsson Foundation, my thoughts turn first, as you may well imagine, to the man whose name this Foundation bears.

For nearly forty years I had the privilege of knowing him as a true and trusted friend. Already before the last war I used to enjoy talking to him about the problems that were arising in the economic field, especially those resulting from the 1929 depression. But it was above all in the immediate post-war years that our relationship became closer and our contacts more regular. At that time I was performing the functions of Governor of the National Bank of Belgium together with those of President of the Bank for International Settlements. This meant that I was to make frequent and fairly long visits to Basle. I shall never forget the lengthy and exciting discussions we had in those days on the problems of economic reconstruction and currency stabilization.

I can say that whenever I returned to Brussels after a few days' discussion with Per Jacobsson I felt firmer in my convictions and stronger in my resolve to pursue vigorously the policy of stabilizing the franc on which my country had embarked in 1944 after its liberation.

It is these memories, I confess, which persuaded me to accept the invitation to speak on this platform today.

* * * *

Much has been written in recent years, and particularly since the end of the war, on economic growth and ways of promoting it. Monetary stability and the means of preserving it have also been the subject of considerable discussion. I have no intention today of embarking on a theoretical study of these questions.

I have, however, in the course of my career had the great privilege of being associated in various countries in the examination and solution of numerous problems pertaining to monetary policy, and I have had the opportunity of appraising, often in widely differing circumstances, the effects and incidence of policy measures in that sphere.

I thus hope that the considerations I am going to present to you—based as they are primarily on my own experience—may shed some light in a debate which has far from run its course.

* * * *

At the end of the eighteenth century, when Adam Smith wrote his famous work "The Wealth of Nations," his main concern was, it would seem, to describe the means which he considered could accelerate economic development and raise people's living standards. This was certainly also the concern of his illustrious successors, David Ricardo and John Stuart Mill, at the beginning and middle of the nineteenth century, and I feel that all the economists in whose school the men of my generation were brought up also had the same preoccupation.

However, if we look at the treatises on political economy written up to about thirty years ago we will find no reference anywhere to what is today called "economic growth."

And yet during the nineteenth and at the beginning of the twentieth century there was remarkable industrial progress in the world and a substantial improvement in the standard of living. But the concept of economic growth as it is known today had not yet been formulated, and the expression "economic growth" had not yet been coined.

Just as Moliere's M. Jourdain spoke in prose without knowing it, so too were the economists of the nineteenth and early twentieth centuries concerned, perhaps also without knowing it, with economic growth.

Some authoritative writers claim, not without irony, that the importance attached to the problem of "growth" in contemporary economic literature is no more than a fashion and a passing craze. Whereas fifty years ago it was customary to study the question of price stabilization and thirty years ago to concern oneself with full employment, nowadays it seems indispensable to have an opinion on economic growth.

Before broaching this subject I should like first to make a digression, for, if the currents that have dominated and even inspired economic thought over the past twenty years are to be understood, it seems necessary to give a survey of certain events of the inter-war years which I was intimately involved in and was able to follow fairly closely. For I am convinced that these events have exercised a profound influence on the thought and action of economists and politicians of our day.

* * * *

At the end of the first world war it was thought in most of the allied countries that international commercial and financial relations would very soon be resumed more or less as they were before 1914.

In Great Britain, for example, it was impossible to imagine that the pound could be devalued if London was to regain its position as the leading international financial center. In order to maintain the confidence that had always been placed in the pound, it was necessary that its convertibility should be restored on the pre-war basis with the minimum of delay. This reasoning appeared perfectly sound and the British Government's decision to safeguard the value of the pound was both honorable and courageous. At the end of the war, however, the pound sterling had suffered a *de facto* depreciation in relation to gold which had at times amounted to nearly 30 per cent. The difficult problem was to bring it back to its former parity.

Nevertheless, the endeavors in this direction achieved success fairly rapidly and fairly painlessly. As early as 1925, partly as a result of speculation on a rise of the pound that started following the announcement of the Government's intentions and also as a result of the flight to London of capital from the continental European countries, the former parity of the pound was re-established. From then on it was a question of consolidating it.

This consolidation implied adapting the British economy and the economies of the Commonwealth countries and the sterling area to a considerably lower price level than that which had been established under the influence of the war-created inflation.

In order to bring about such an adaptation and to overcome the effects of this inflation, a tight restriction of credit and a policy of deflation in all areas should have been instituted.

To a limited extent, this deflation set itself in motion in 1926, when, after the stabilization of European currencies, a certain amount of capital that had sought refuge in London began to be repatriated.

Nevertheless, the return of the pound sterling to the prewar parity was making prices high on the British market, especially in comparison with prices in other European countries whose currencies had been devalued.

The effect of this situation on the British economy was one of deep stagnation and mounting unemployment.

Thus the idea was born and nurtured in the minds of workers and politicians that monetary stability was the cause of this depression and unemployment and all the other difficulties with which the country had to cope.

Those who saw the situation in this way did not understand that the policy followed until then had been intended not to *stabilize* the pound sterling but to *revalue* it.

Like all the other belligerents, the United States had also had to allow a certain amount of inflation during the war, but this did not affect the international position of the dollar. This inflation had, however, brought about unrestrained speculation in the postwar years, which in November 1929 led to a sensational crash on the New York Stock Market and to a crisis that shook the economy of the whole world and caused prices to fall drastically.

This crisis very soon made itself felt in the United Kingdom and further aggravated the difficulties which this country was already facing.

Under pressure of these events the British Government was forced in 1931 to abandon the fight it had so steadfastly been waging for ten years and to devalue the pound sterling.

However, it was not the policy followed up to then that was blamed, but the gold standard.

Instead of recognizing that the policy followed up to that time was being given up and saying that the parity of the pound sterling was being brought to a level more suitable to general conditions within the country and the world outside, it was simply said that the gold standard, the principal cause of the difficulties, was being abandoned and that henceforth the main objective of monetary policy would be price stability. From now on the rate of the pound would have to find its level on a market governed by the law of supply and demand.

It goes without saying that this decision, which represented a radical change in Great Britain's financial policy, had far-reaching repercussions on that country, on the Comonwealth, and on the whole world.

The devaluation of the pound sterling was followed by that of the currencies of most of the Dominions and British colonies and of a number of other countries. Less than two years later, in 1933, the dollar was also devalued, as finally, in 1935 and 1936, were the currencies of the "gold-bloc" countries, Belgium, France and Italy, which had been stabilized a few years before after a substantial devaluation, and those of the Netherlands and Switzerland, whose parities had up till then been maintained at their pre-war levels.

Reasons of prestige prevented Hitler's Germany from following suit.

That country was, however, in the throes of a profound depression, which had set in in 1929 after the large-scale withdrawal of short-term capital, mainly American, invested there during the boom that had followed the stabilization and conversion of the mark in 1924-25. There, too, the crisis had given rise to acute deflation, resounding bank crashes and, finally, a general moratorium on German external debts.

The suffering which it caused was certainly not without bearing on the success of Hitler's propaganda.

Instead of devaluing its currency, Germany established extremely strict price, exchange and foreign trade controls, enforced by the severest penalties. Under cover of these it was able, after a short while, to begin rearming and preparing for war, financing this by a more or less controlled inflation.

For some years Germany succeeded in this way in creating the illusion in the outside world of having been far more skilful than other countries in its economic and financial policy, since it appeared to have managed to solve its problems without openly devaluing its currency.

After the outbreak of war in 1939 all the controls previously introduced were made even tighter. They were soon applied in German-occupied countries too in order that all the latter's resources might be directed towards the war effort of the Third Reich.

Most of the other belligerents were also obliged by the necessities of war to apply a policy similar to Germany's, which justified itself by the need to win the war at any price.

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Towards the end of the war, in 1944, it was generally believed in the western countries that demobilization would lead to considerable unemployment, and this prospect naturally gave rise to serious concern.

Appraisal of economic development prospects was, moreover, distorted by a false interpretation of the experiences of the inter-war period.

Distrust of the gold standard and of monetary stability as it was conceived under that system was still very far from being dispelled, and the ideas put forward by Keynes in 1936, even though not always clearly understood or correctly interpreted, had very rapidly gained ground. The experiment of a controlled economy made in Germany with apparent success after Hitler had come to power, and those which all the belligerant countries had made during the war, drawing upon the means of coercion provided by war conditions, had left a deep impression on those who were called upon to decide on economic and financial policy.

At the end of the war, therefore, stress was deliberately laid on achieving full employment and increasing production as quickly as possible, whereas it seemed that other essentials for economic expansion could be neglected.

It was regarded as absolutely necessary, in particular, to pursue a policy of easy and cheap money without worrying unduly about monetary or price stability. This, it was thought, would be assured, as it had been during the war, by controls on prices, exchange and foreign trade. These were all the easier to apply as trade was severely hampered by the shortage of means of sea and land transport.

This reasoning explains most countries' reluctance to ensure the defense of their currencies by means of credit policy and to get rid of the controls established during the war.

* * * *

The pursuit of expansion at all costs also accounts for the interest that the study of the problem of growth began to awake at that time.

This interest was heightened by the fact that, during the war, government influence over economic life had been greatly extended. Administrative bodies had been created to co-ordinate the activities of the various sectors of industry and to obtain the best possible return from the limited resources available. These bodies had become accustomed to viewing every problem in relation to the country's overall economic activity. Much more than in the past, economic frontiers had become, in a way, aligned with and superimposed on political frontiers.

As had long since been the practice in communist countries, many countries had set up—or proposed to set up—planning or programming offices entrusted with the task of preparing estimates, drawing up plans and programs and, on occasion, giving general directives to the economy.

The desire to give these plans a rational basis and to show the results of their execution soon brought out the need, as also in the case of the communist countries, to express the expansion and prosperity the authorities were seeking to promote in terms of figures and ratios.

The practice therefore spread of making an annual estimate of the "national product," i.e. of the total value of the goods and services produced in the country.

It was by comparing the estimates of the national product for two years that what is nowadays called the growth rate of the economy began to be calculated.

* * * *

I have just said that the "national product" is an *estimate* of the value of the goods and services produced in a country in one year. I must particularly emphasize the word *"estimate."*

For, while fairly accurate statistics can be obtained for some of the items that have to be taken into account in calculating the national product, this is, in the nature of things, not possible for others—such as services of all kinds. In such instances recourse must be had to estimates, which, though certainly not arbitrary, are nevertheless always only approximate, since the foundation on which they are based are almost invariably rather insecure.

In order to make these growth rates more comparable, an attempt is usually made to eliminate fluctuations that are due to changes in price levels. The figures for the national product are then adjusted on the basis of the price indexes. However, a new source of error is thus introduced into the comparisons—or at least into international comparisons—because, more often than not, the price indexes are not calculated in the same way in the different countries.

Generally speaking, in the case of a single country, figures calculated by the same people on the same basis over a number of years may give a more or less true idea of the development of the economy. In terms of absolute value, however, these figures should be treated with very great caution and reserve.

If they are to be compared with those drawn up in other countries, by different people and often by different methods, it is easy to see that even greater caution and reserve will be called for.

The profound differences that exist in the economic and political structure of the various countries may, if one is not sufficiently familiar with them, also be a factor tending to rob international comparisons of virtually all value.

The coming into operation of a new factory in a country where industry is only in its infancy and the economy is still a primitive one will obviously have a much greater effect on the growth rate of that country than the opening of such a factory in a highly industrialized country would have on the growth rate there.

These few remarks on the subject of growth rates clearly show, I believe, the danger that there may be of drawing too hasty or too rigid conclusions from them.

I have nevertheless tried to see whether the figures that are available support the argument advanced by certain economists that a slight degree of inflation reflected in a moderate increase in prices tends to encourage growth.

A careful analysis has been made of various tables drawn up by the Bank for International Settlements which compare, over a fairly long period, the average annual growth rates in a number of countries with the average annual increase in prices in the same countries.

I am afraid that I now have to give you some figures; I hope you will forgive me.

The period considered extends from 1900 to 1963. Here, as briefly as possible, are the results of this analysis of the BIS's figures.

These relate to a first group of countries—Norway, Sweden, the Netherlands and the United States—where the average annual growth rate, calculated on the basis of constant prices, is comparatively high and in most cases greater than the rise in the general price level. For Norway the growth rate is 3 per cent, while the rise in prices also works out at 3 per cent. For Sweden the figures are 3.1 per cent and 2.8 per cent respectively; for the Netherlands 2.7 per cent and 2.5 per cent; and for the United States 3 per cent and 2.4 per cent.

In a second group of countries, comprising Italy and France—which, it is true, suffered particularly from the consequences of two world wars—the average annual growth rate during the same period is smaller, and distinctly lower than the average annual rise in prices, which appears very marked.

For Italy the growth rate is only 2.4 per cent, compared with a price rise of 10 per cent. In the case of France, the growth rate is also 2.4 per cent, while the price rise works out at 9.5 per cent.

Finally, in the United Kingdom the growth rate is also noticeably lower than the price rise. The former comes to 1.9 per cent and the latter to 2.3 per cent.

By taking a very short period it would perhaps be possible to find a relationship between substantial price increases and high growth rates, but the explanation for this phenomenon might also, in my opinion, be that excessive demand tends to push up prices, while rising prices do not bring about higher growth rates.

In any case, even if the last ten years, from 1953 to 1963, are considered, there is no evidence of such a relationship between inflation and growth.

It is found that during those ten years the European countries with the highest growth rates are, in order: Germany—7 per cent, Italy—6.2 per cent, Austria—5.6 per cent and Switzerland—5.2 per cent.

These countries also show the best results as regards prices, with rises of 2.7 per cent, 2.7 per cent, 3.3 per cent and 2.6 per cent respectively.

The same might be said of the United States. Between 1953 and 1963 the average annual growth rate was around 3 per cent, while the general price level rose by less than 2 per cent a year.

In view of the caution which is necessary whenever figures of the type I have just quoted are examined—even when they are taken from the best sources—the least debatable conclusion to be drawn from the analysis just made is that no definite relationship is apparent between the rise in prices and economic growth.

In no case could these figures be quoted in support of the theory that monetary stability is an obstacle to growth.

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If we now leave the study of statistics and proceed to analyze the economic mechanism and the historical facts, it appears immediately that *monetary stability is one of the essential conditions for rapid and lasting growth because it is the most powerful force behind the formation of savings, without which it is impossible to carry out the investments that are indispensable for such growth.*

Indeed, it has been observed that as soon as a currency's stability is questioned and a large section of the community begins to realize that there is a danger of devaluation, saving rapidly tends to slow down.

Those inclined to save have every reason to fear that they will later find that the purchasing power of their savings is smaller than it is now. They consequently prefer to utilize them either for consumption expenditure or for the purchase of foreign currencies in which they have more confidence than in their own.

Monetary stability is also essential to win the confidence of foreign capital, which, if the yield prospects are good, can be expected to supplement the supply of domestic savings available to finance the country's investment needs.

The necessity for a stable currency, which is important in developed countries, is equally so in developing countries because it is only through an inflow of foreign capital that they can hope to speed up their growth rate on a sound basis.

It is a well-known fact that nearly all the highly-developed countries were obliged, in the early stages of their advance, to supplement their meagre savings with capital from other countries. England borrowed capital from Holland in the seventeenth and eighteenth centuries and has, in its turn, lent to nearly every country in the world during the nineteenth and twentieth centuries. The United States, too, was a frequent and heavy borrower in Europe during the nineteenth century. Now, however, it has become the richest country in the world and its principal creditor.

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Monetary stability is likewise necessary to encourage a rapid increase in productivity, which is also fundamental to economic growth.

In countries where the currency and prices have been stabilized, firms can no longer make the easy profits on their stocks that they were able to when prices were continually rising.

They can also no longer hope to repay in depreciated money loans contracted in the past.

In order to remain competitive on world markets, they are therefore permanently faced with the need to keep down their costs and to make continual improvements in production methods and overall organization.

* * * *

The analysis which I have just made is strikingly confirmed by the experience of the past twenty years, which brings out particularly forcefully the influence of monetary stability on development and growth.

In Europe we have seen since the end of the war that, as soon as a country has decided to take the necessary measures in the credit field to re-establish the stability of its currency and to defend it within a liberal framework, many problems which had previously seemed insoluble have quickly been resolved and the country has once more enjoyed considerable prosperity.

This was the case in Belgium from 1946 onwards, in Italy from 1947, Germany after 1948, the Netherlands after 1949, Austria after 1951, the United Kingdom after 1957, France after 1958 and Spain after 1960.

Switzerland, whose currency has not been devalued since 1936, has enjoyed uninterrupted—and even, to a certain extent, excessive—prosperity since the end of the war. It owes this state of affairs above all to the confidence which its currency inspires throughout the world. This confidence is based on the fact that the Swiss authorities have in the past always defended the country's monetary stability and are known to be determined to pursue the same policy in the future.

This policy put at the disposal of the country all the capital it needed for its development and in addition allowed it to invest large sums abroad. This prosperity is best illustrated by the fact that sharing in it today are 750,000 foreign workers who transfer a large part of their earnings to their home country to support their families there.

Experience in countries outside Europe has been similar.

Mexico, which since the war has resolutely defended the stability of its currency, has shown a spectacular rate of development over the past fifteen years within a framework of very great political stability.

The same applies to Japan, where the average growth rate, in terms of constant prices, during the period 1954-63 was 30 per cent higher than that in Germany and two and a half times as great as that in the United States.

This development is attributable to the large volume of new investment, which has been financed by both domestic savings and capital from abroad. It is also attributable to the big increase in labor productivity.

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The beneficial influence of a stable currency on economic growth thus seems to be clearly borne out both by abstract analysis and by practical experience.

Consequently we may wonder why this aim of monetary stability is not pursued with greater energy and conviction, since all governments never cease to declare that they are in favor of it—even when the policy they are pursuing is bound to have the opposite result.

The reason is clear. *It is that monetary stability requires a discipline to which governments elected by universal suffrage are not always willing to submit.*

This discipline entails firstly avoidance of any direct or indirect creation of fiduciary money to cover a possible budget deficit.

This means that to carry out its budget, the government can only obtain its funds from taxation or borrowing.

But, in any country, before monetary stability makes itself felt in an expansion of savings or in an increase of confidence permitting greater recourse to the capital market, a fairly long period of time is bound to elapse, during which—if it fails to cover all its needs by borrowing—the government must rely mainly on fiscal revenue. During this period, therefore, it will find itself unable to carry out the plans it has made. It must then draw up a list of priorities of tasks to be performed, and postpone, spread over a longer period, or even simply abandon the projects that appear least essential. This is an unpleasant situation for many politicians who would like to be able to satisfy all demands and at the same time not make heavier calls on taxpayers.

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The discipline that monetary stability calls for also entails free manipulation of the most effective instrument for the defense of price and monetary stability: the interest rate. That is why the latter must not become a rigid element in the interplay of economic forces.

On the contrary, it must respond freely to the impulses acting upon it and be adjustable without difficulty and, above all, without delay whenever the necessity makes itself felt.

In every country rises in the interest rate unfortunately invariably meet resistance because it is generally considered that high interest rates paralyze growth and that low rates, in contrast, promote and stimulate it.

Although this view is no doubt fundamentally correct, it becomes dangerous when it is formulated and applied rigidly and over-simply, without taking into account the other factors conditioning an appraisal of the situation to be dealt with.

The question may in fact be asked what constitutes a high rate and what constitutes a low rate. It is impossible to give a clear-cut answer to this question as the interest-rate level is essentially a relative concept. At a given time one and the same rate may be regarded as low in one country and appear as excessively high in another. In fact, in every country the rate of interest depends on a great many widely differing factors whose influence varies according to the particular conditions prevailing in each of them.

The important thing if one is to form a true judgment of the rate appropriate on a given market is to be free of any preconceptions and refrain from considering *a priori* a policy of cheap and easy money as good and a policy of dear and scarce money as bad.

Actual experience shows that, in spite of relatively low interest rates, certain countries develop only slowly, while others which have rates regarded as high advance rapidly.

To illustrate the point that cheap money is not the only factor to be taken into account in the aim of securing expansion, growth and full employment, I cannot do better than cite two concrete examples which are drawn from the experience of recent years and which all of you will have witnessed.

The United States, where for over thirty years a policy of easy and, in general, fairly cheap money has been pursued, has frequently had a comparatively high level of unemployment in that period.

In Japan and Germany, on the other hand, a policy of rather dear and scarce money has been maintained over the last fifteen years. Both these countries have experienced rapid and substantial expansion together with a steady increase in the working population and a very low unemployment rate.

With regard to the effectiveness of relatively high rates to remedy a difficult situation, a striking example is furnished by the United Kingdom at the end of 1957. That country decided at that time to re-establish without delay equilibrium in its balance of payments and restore confidence in the pound sterling. It raised Bank rate to 7 per cent, whereas it had previously been 5 per cent, compared with discount rates of only 2 per cent in Switzerland, 3 per cent in the United States and 4 per cent in Germany.

The move was extremely effective, and after six months the rate could be brought down to 6 per cent and in the following six months progressively lowered to 4 per cent.

The increase in Bank rate would no doubt not have had to be as great if it could have been made earlier. The results, and the speed with which they came about, clearly show, however, the adaptability of the economy and the ease with which it can be set moving when there is the will to do so.

I should like to quote here some words of Per Jacobsson which admirably bring out the necessity, in matters of economic and financial policy, of being free of preconceived ideas and of basing one's decisions, above all, on the prevailing circumstances:

"In economic matters," he said, "one should always be prepared for the unexpected. Consequently one must not be rigid. The kind of measures which meet the needs of one situation may have to be reversed before many months have passed. There is a time for cheap money; and another for dear money; it all depends upon the circumstances, and especially on the dominant trend of business activity on each particular occasion."

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Manipulation of the interest rate unfortunately always has particularly strong political repercussions. That is why, in the government of a country, monetary policy occupies a position of its own. The exercise of monetary policy calls for deep technical knowledge and an experience that most politicians do not possess. That is why I believe that it must be entrusted as far as possible to specialists and not be too closely dependent on general policy.

In the field of monetary policy, any mistakes or, what is even more serious, a simple failure to act when action is called for have deep repercussions on the lives of the members of the community. All of them, without exception, receive and spend money in carrying out their daily tasks, and any change in the value of money has a profound effect on their lives and those of their families.

Mistakes and inaction hardly ever work in the direction of deflation, and, if they should happen to do so, measures to restore the situation would not be long delayed because nothing would stand in their way. Man's natural tendency, indeed, is towards optimism and expansion rather than towards pessimism and restraint. That is why the general public always speculates for a rise and never for a fall, and regards bear speculators as iniquitous.

In the field of monetary policy, in fact, mistakes and inaction invariably work in the direction of monetary inflation and rising prices.

When the first signs of such inflation appear, one always hesitates on one pretext or another to take action, because, rightly or wrongly, one is afraid of halting or slowing down an expansionary movement that is to everybody's satisfaction.

Thus the causes of the inflation persist and its effects gather strength, until the time arrives when deficits appear in the balance of payments, gold begins to leave the country in consequence, and the threat looms up of a possible devaluation of the currency. As it is known that such a step would be fatal, recourse has to be had to deflationary measures. These are never popular. In our social system they meet strong opposition and can generally only be applied for a limited period of time.

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It is primarily in order to avoid the need for deflationary measures that inflation must be relentlessly combated whenever and immediately it appears. It works its way into the economic system by many different paths, but at its roots there is nearly always to be found a disregard of the principles that must govern the creation of money.

The most obvious form of inflation is that of direct advances made by the central bank to the government to meet a deficit in its liquidity position, which often turns into a deficit in its budget. Operations whereby the central bank buys, to hold in its own portfolio, government securities on the market in order to support their price and prevent a rise in interest rates indirectly lead to the same result.

It is not, however, only these direct or indirect advances to the government that produce inflation.

Another source is the discounting by the central bank of commercial paper which is ostensibly at short term but is provided with a renewal undertaking that transforms it into long-term paper.

An even more insidious form of inflation is that which may be described as "imported from abroad."

This began to make itself felt during the last war, and in particular at the end of it, at a time when there was as yet no question of currency convertibility and when every country was endeavoring to safeguard jealously its gold reserves. It came about in the shape of bilateral payments agreements between governments, involving the opening on a reciprocal basis of credits—sometimes for large amounts—by the central banks of the contracting countries with the aim of avoiding gold movements in the event of temporary imbalance in payments between the two countries.

Experience showed that in practice a small number of central banks, which had defended themselves against inflation better than others but which were tied to these others by a network of agreements of the kind just described, found that the credits they had opened were being utilized to the full and simultaneously by the majority of their partners. As a result, those banks accumulated a considerable volume of claims in inconvertible currencies corresponding to credits which had no fixed maturity, could not be mobilized, and in many cases bore interest at an exceptionally low rate.

These credits certainly enabled the recipient countries to postpone the application of measures to correct their balances of payments, but at the same time they were at the origin in the creditor countries of a persistent and at times excessive demand for goods—a direct cause of rising prices.

The restoration of currency convertibility has not eliminated this form of inflation.

It occurs today, in very much the same way as before, when, as a result of agreements between central banks, certain of them are again called upon to grant credits to others which enable these others to put off settling their balance-of-payments deficits in gold when they are hesitant or slow to apply on their own market measures that could bring the deficit to an end.

For the banks concerned, such credits, whatever their form, ultimately always develop into long-term credits, which under the rules of sound monetary policy should never be granted by central banks.

To prevent the credits from having an inflationary effect in the countries granting them, it should be possible for them to be financed by the issue on the capital market of medium-term bonds by the borrowing countries and not by means of the creation of new payments media by the central bank.

In that case the granting of such credits would certainly be much more difficult and no doubt there would be less heavy recourse to them.

The credits just discussed constitute, it is true, one of the forms of indispensable co-operation that must exist between central banks in order to defend the stability of the foreign exchange market and the maintenance of exchange parities; the object of this co-operation will only be really achieved, however, if the granting of such credits remains subject to strict rules to limit their duration and if the rules are always scrupulously observed.

It seems clear that such rules ought to be established and put into force for a certain length of time before one can usefully and with full understanding proceed to study what is today called the "problem of international liquidity."

In the exercise of monetary policy it has today become indispensable to take into consideration not only the domestic situation in one's home country but also the situation in foreign countries.

More rapid transportation has overcome the barrier of distance, and the development of international relations is such that the interdependence of countries is daily growing closer.

The contacts between central banks have never been so numerous and the solidarity uniting them has never been so great. What goes on in one country can no longer be a matter of indifference to the others, and each has to take account of that in framing and applying its monetary policy.

This necessity makes itself most strongly felt in the small highly industrialized countries, where the volume of external transactions is comparatively large in relation to the whole of their economic activity; it is perhaps less clearly evident in the larger countries, where the ratio of external to internal transactions is necessarily smaller. Nevertheless, countries like the United States, and even eastern-bloc countries, can, in framing their monetary policies, today no longer ignore events taking place beyond their frontiers, because, whether they like it or not, they are bound, sooner or later, to feel certain repercussions from them.

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To ensure a better defense against the various possibilities of inflation, it seems essential that the monetary authority should enjoy a large measure of independence vis-à-vis the political authority in spite of the wish that some people may have to subordinate the former to the latter.

The divergences between the viewpoints of governments and central banks are, in my opinion, of a structural character, and they should be accepted in the very interests of the institutions concerned. The fact that such differences exist is the best evidence that the institutions are functioning well.

Ministers of finance and those responsible for monetary policy are bound, by very reason of their differing responsibilities, sometimes to have divergent views on how to resolve the big financial problems. The former, who have to take certain political factors into consideration, will tend to regard these problems in a short-term context without being able to concern themselves too much with the longer-term consequences of their decisions. The others, on the other hand, by reason of the permanent nature of their office and the technical background they must possess, will generally take fuller account of the longer-term implications of their decisions.

It is the confrontation of these two viewpoints that will ultimately enable the best solution to be found to the problems to be solved.

Some people may perhaps feel that, in the event of profound disagreements on the policy to be pursued, means should be provided of arbitrating on the divergent opinions, or that the government should be afforded the possibility of imposing its views. In the light of my own experience, I for my part believe that it is better not to make any such provision but to rely on human wisdom to find—while avoiding as far as possible public debate—the most fitting solution in the circumstances. The influence of the monetary authority will always be the more effective, the greater the discretion with which it is exercised.

To guarantee the independence of the monetary authority, it is in my view essential that those exercising it should be appointed for a fairly long term of office and that it should only be possible to dismiss them in the course of their mandate by means of an exceptional procedure.

It is also necessary—and this goes without saying—that as far as possible the expiry of their periods of office should not coincide with the expiry of political mandates.

Finally, where monetary policy is in the hands of a committee, it is important that the mandates of its members should be properly staggered so as to reduce and delay the influence on the committee as a whole of changes that may occur in the political government.

In this connection, the system in force in certain countries of replacing the governing officials of the central bank after any change of government is extremely dangerous because it lends a political character to functions that should only be exercised by technical specialists—in complete independence.

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The independence of the monetary authority from the political authority is not enough in itself, however, to ensure a really effective defense against inflation.

It is essential that this independence be supplemented by legal provisions giving those responsible for monetary policy a secure foundation which will enable them to resist effectively any pressure that the government may be tempted to exert on them.

In countries where such legal provisions do not exist, the first duty of a finance minister who is conscious of his responsibilities should be to have them adopted.

It is essential above all that the legislation governing relations between the political and monetary authorities should set a very strict limit to the volume of advances that may be granted, in whatever form, by the central bank to the public treasury. In view of the uncertainties of economic development, however, this limit should not be absolutely rigid. The possibility should exist for it to be exceeded by a certain amount in exceptional circumstances by means of a procedure similarly of an exceptional character and for a strictly limited period of time.

The considerations I have just presented have been inspired mainly by the experience of developed countries, such as the countries of western Europe and the United States.

I think that they are equally valid for countries in the course of development, even those which are as yet still in its early stages.

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It would be a profound and dangerous illusion for the governments of those countries to believe that, of the many problems facing them, that of maintaining monetary stability is of secondary importance and that it is still possible in the world of today to ensure such stability by strict exchange and price control under cover of which inflation can freely take its course.

It is certainly still possible by means of such control to preserve the semblance of monetary stability for a limited period of time, but, if the inflation gathers strength, such stability, which is based on constraint, soon ceases to have any meaning and leads to an impasse. The course of events is always the same no matter what country is involved. Under the effect of persistent inflation the supply of foreign exchange declines because the holders want to obtain for it—quite rightly—the full value, which the official rates, fixed by authority, can no longer give them.

To preserve a certain degree of equilibrium in the market, there is soon a move to restrict and subsequently to stop the transfer abroad, first of amortization payments and then of income from capital invested in the country. Authorization to purchase or pay for imported goods is refused —or delayed. Imports thus very soon become paralyzed. Exports also fall off because those holding export goods prefer not to sell rather than sell at too low a price. If, nevertheless, some export transactions do take place, the exporter endeavors to repatriate as small a part of his earnings as possible and to hold the rest abroad until the arrival of better times.

The official foreign exchange market soon loses all significance and it is not long before a parallel market—which may take many various forms—comes into being. Its size and effectiveness depend only on the stringency of the penalties imposed on those who have recourse to it.

The country's economy is in any case destined to stagnate until such time as the government collapses and makes way for new men.

In many countries experiencing social and political problems, it is generally insufficiently realized that these often have their roots in the continual depreciation of the currency, the consequent rise in prices and the resulting insecurity.

The constant rise in prices is a source of anxiety to the families of wage and salary-earners, whose incomes never keep up with prices and who see before their eyes the wealth and luxury of those who, taking advantage of the fall in the value of money, reap easy profits and make huge fortunes. *It is thus not surprising that countries in a state of monetary instability are generally a prey to disorders, revolutions or civil war—the precursors of a repressive system of government.*

It may certainly happen that at the origin of monetary disturbances are to be found political difficulties. However, it is extremely rare for profound monetary disturbances not to lead in a very short time to political unrest.

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In conclusion, it seems to emerge clearly both from abstract analysis and from observation of economic and monetary phenomena that in economic and social life two essential objectives can be pursued concurrently in order to achieve an expansion of production and an improvement in the standard of living: political and economic freedom and monetary and price stability.

These objectives by no means conflict with each other; in fact I am convinced that they are, on the contrary, complementary.

No one has held this conviction more firmly than Per Jacobsson, who gave admirable expression to it in the following passage, which I should like to quote in concluding this rather over-lengthy address:

"It seems to be a lesson of history that without stable money neither justice nor progress can be assured, and that the human spirit cannot give of its best if it is harassed by all the uncertainties to which rapidly changing money values give rise. Nations, too, must have their self-respect (which is something other than nationalistic pride), and enjoy the esteem of other nations; but this cannot be obtained without the benefits of a sound currency." Modern money depends on credit; and credit cannot be separated from confidence. Questions of monetary technique play a rôle—even a great rôle—but above them stand the moral requirements of a sufficient determination and will to co-operate—nationally and internationally—"so that proper solutions can be found to the many problems which arise in the management of the monetary system."

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MR. BURGESS: Thank you, Governor Frère. I wonder if we would not all agree that we have just heard the voice of experience. For I am sure that Maurice Frère could document each one of his statements from his own experience. I know you will all want to study his speech, and I can tell you that our Foundation will publish today's two speeches in three languages—English, French, and Spanish—and will have them available for all those who wish them. They will go automatically to all Sponsors and all contributors. I am glad to tell you also that the International Monetary Fund will print the speeches in full in its November 20th INTERNATIONAL FINANCIAL NEWS SURVEY.

You have heard one voice of experience; now we have another. You have been listening to the doyen of the central bankers of Europe; now we will turn to the dean, the doyen, of the central bankers of Latin America. He has been on the job longer than any other central bank head in that area and has probably accomplished more than any other. He has done a wonderful job in Mexico, which has earned him an appropriate place on this program beside Maurice Frère. I have the great honor of calling upon Don Rodrigo Gómez to speak to you.

LECTURE

by

RODRIGO GOMEZ

Director General, Bank of Mexico

IN selecting the General Director of the Bank of Mexico to present the experience of a developing nation, the Per Jacobsson Foundation has conferred a great distinction upon my country. My participation in this first program of international lectures is especially gratifying to me because this institution honors the memory of Per Jacobsson, a wise and admirable man, a warm friend and a great financier, whose advice was beneficial to such a large number of countries. This honor, like any honor, implies a great responsibility, more so in view of the controversial and important topic that has been assigned to me, namely: development with stability.

There is little that I could add, from the academic standpoint, to what distinguished economists in many parts of the world have said already on such a widely discussed subject. The significance of what I shall contribute lies rather in the account I am able to give of events of great importance in the economic life of my country—events that I have not only witnessed but in which I have actively taken part. I shall be particularly concerned with Mexico's use of monetary and financial weapons in its struggle against inflation and in its pursuit of economic development. This may shed some light on the effects of certain policies and may be of interest for those who are studying similar economies. I would like to emphasize that our anti-inflationary policies have never sought stability as an end in itself. Rather, they have been conceived as measures designed to achieve high and sustained economic growth and to continue raising the standard of living of our population.

Mexico's social, economic and political life was shaken to its very foundations by a revolution whose most violent stage covered the years from 1913 to 1923. During this period, the monetary and banking system almost entirely disappeared. Bank notes issued at that time by certain commercial banks suddenly dropped in value, or were withdrawn from circulation, and those widely circulated by different revolutionary factions eventually became worthless. The consequent loss of confidence in paper money and banks in Mexico lasted well into the nineteen thirties. Private banks surviving the revolution discontinued the issuing of bank notes, practically suspended loans, and devoted themselves to operating in collections, exchange, remittances and letters of credit, both in domestic and foreign markets.

During the twenties, United States currency and Mexican gold coins circulated side by side. However, under our *de facto* gold exchange standard, we were constantly at the gold-export point, and, though exports of gold coins were prohibited, they were sent out of the country as fast as they were minted from newly-mined gold, and were sold at current prices for their metal content minus the cost and risk of their being smuggled abroad.

Mexican copper and silver coins were then the principal means of payment for everyday transactions. Their face value exceeded their metal content value and they were minted and put into circulation faster than the market required, enabling a mild credit expansion to take place. Part of the mintage profits were used to cover expenses of the public sector. The exchange rate on the silver peso fluctuated, but tended to fall with respect to the dollar on a free exchange market. The domestic price level rose as the foreign value of the silver peso declined. There was practically no gold and foreign exchange reserve in Mexico. There were no bank notes, hardly any bank deposits (either sight or time), no bank loans and no fixed-income securities (public or private). Since we had no monetary reserves, no credit abroad, and rates of exchange were freely determined on the market, there were, strictly speaking, no payments problems, although there was clearly an underlying external disequilibrium.

With silver coins as the principal means of domestic payment, it was natural that a constant drop in the purchasing power of these coins would cause public dissatisfaction. An increase in prices is an issue dear to the hearts of opposition parties, the press, and housewives, who, as we all know, represent a powerful force in shaping public opinion. At the same time, industrialists, merchants, and businessmen in general were hampered in carrying out their operations and making long-range plans. It was within this set of circumstances that I entered the central bank in mid-1933. I had been working in commercial banks since 1919. My task now was to help stabilize the peso. Shortly after I joined the Bank of Mexico, the price of gold in the United States was fixed at 35 dollars per Troy ounce. The rate of exchange of the peso was then set, in November 1933, at 3.60 per dollar—that is, 27.78 U.S. cents per peso.

The gold and foreign exchange reserve was very small, but the money supply was also low. In other words, liquidity was practically nonexistent. After a long period of transactions carried out at fluctuating rates, we had a realistic rate of exchange set by the market itself. Precisely because of this, the Bank of Mexico did not find it too difficult to maintain this rate in the immediate subsequent years.

Important social reforms were carried out in Mexico in the late thirties. Their effect on the money market was complicated by a budgetary deficit in 1938 which, although relatively small, had to be financed entirely by the Bank of Mexico through issues of bank notes in which the public had already begun to have confidence. The internal situation worsened as a result of a recession in the United States, and Mexico's low gold and foreign exchange reserve was depleted. In February 1938, it was necessary to unpeg the exchange rate set at 3.60 pesos per dollar and allow it to fluctuate for some months under the surveillance of the central bank, with an eye toward avoiding sharp fluctuations and replenishing and increasing the monetary reserve. Fluctuations indicated that a rate of approximately 5 pesos per dollar was adequate. Thus, a new rate of 4.85 was set in November 1940 which lasted until 1948.

The economic analysis of this period, 1938-1948, is complicated and obscured by World War II. During these years, the price level in Mexico rose more than in the United States, which meant at first an overvaluation of the peso. When price control ended in the United States, price parity was re-established and we again had an apparent equilibrium rate. But there was a widespread deferred demand for capital goods and durable consumer products from abroad along with a high liquidity in bank notes and bank deposits. Furthermore, the external purchasing power of Mexico's foreign exchange assets had declined as prices of manufactures went up in the industrial countries. The situation was further aggravated by a budgetary deficit financed by the central bank. In these circumstances it would have been difficult to bring about a classical adjustment of domestic demand to restore balance of payments equilibrium.

In 1947-48 there was a recession in the U.S. economy again, with a corresponding drop in the prices of some of Mexico's stable exports. This brought about a substantial decrease in our foreign exchange income, and weakened further the budget position, since taxes on foreign trade were a substantial part of fiscal revenue.

Nevertheless, a maximum effort was made to maintain the exchange rate. We used up our monetary reserve and, at the same time, utilized short-term credit in the International Monetary Fund and the U.S. Treasury. Although additional short-term credits were offered to us, such offers were subject to our balancing the federal budget, and this would have been impossible in the short run. The rehabilitation requirements of the government-owned railroads alone were sufficient in themselves to prevent the balancing of the budget. It was impossible at this time to obtain long-term financing, either from domestic savings or from abroad. Moreover, even if we had accepted the additional credits offered to us, they would not have been enough to offset the increases in imports induced by the unavoidable federal budget deficit. Any additional limitation of public expenditures would have been unacceptable, as income per capita had been falling since 1947. It was not possible to foresee the duration of the United States recession, nor to know how long physical and human resources could remain idle before re-establishing balance of payments equilibrium. Under these circumstances, the rate of exchange was again allowed to fluctuate for some months according to market conditions and was newly set in 1949 at 8.65 pesos per dollar, or 11.56 U.S. cents per peso.

The effect of moving from 4.85 to 8.65 to the dollar was to undervalue the peso and produce a considerable scarcity of money on the market. Prices of imports were immediately raised in the same proportion as the devaluation of the peso, while the domestic prices of exports followed the same pattern, minus the export taxes which were then established. Prices of all domestically consumed goods tended to rise, as well as wages and the cost of services. However, the price ratio advantage was fairly rapidly lost, mainly because, once liabilities to the International Monetary Fund and the United States Treasury were met, increased exports and the additional domestic demand, accompanied by an expanded money supply, exerted an upward pressure on domestic prices.

By 1951 approximate equilibrium was again reached. The rate of the peso was adequate—neither over-valued nor under-valued—and the price ratio continued to be more or less stable until 1954.

In Mexico's case, it must be remembered that the bulk of its trade is carried out with the United States of America, over a more than 2,500 kilometer border that makes adequate customs vigilance difficult. Although our foreign trade has been diversified increasingly, in exports as well as imports, the greatest single line of foreign exchange income continues to be tourism and border transactions. For these principal reasons, the actual establishment of exchange control has never been attempted. Instead of a system of multiple exchange rates, a policy of taxing exports and imports at varying rates has been followed.

In an underdeveloped country such as Mexico, where the population makes limited use of money as a store of value as compared with utilizing it in everyday transactions, credit expansion primarily leads to increases in the volume of the money supply employed in economic transactions. Excess credit expansion is not maintained in the form of liquid assets in domestic currency. Rather, as a result of the system of free convertibility that exists in Mexico, it reverts to the central bank in demand of foreign exchange to pay for additional imports or for hoarding purposes.

By 1953, the excess of credit generated in the banking system, principally through the central bank's financing of the public sector, began to drain the reserve of the Bank of Mexico. Since it appeared that the already foreseen budgetary deficit could not be avoided nor financed without further primary expansion of the money supply, and because 1953, as 1947*, was a year in which the increase in our gross national product was less than that of the population, drastic steps had to be taken. Rather than face a total loss of monetary reserves as in 1948, or become heavily indebted once more to the International Monetary Fund and the United States Treasury, our government decided again to devalue the peso. Our purpose in 1954 was to maintain intact our own reserve, as well as the secondary reserves abroad, in order to be ready to face any extraordinary demand brought about by the new devaluation.

Besides carrying out the operation under great secrecy, thus avoiding speculation, the rate of exchange was not allowed to fluctuate for even a day. The fixed rate was adjusted overnight from 8.65 to 12.50 pesos per

* 1947 and 1953 were the only years in the last two decades in which the population increase exceeded that of the gross national product.

dollar, or 8 U.S. cents per peso. Our intention was especially firm in the sense of strengthening efforts toward definite stabilization, but public reaction in the wake of the 1954 devaluation was even more severe than in 1948. The whole country was against it. Yet, paradoxically, many sectors continued being fervent supporters of the very factors that bring about devaluations.

After the 1954 devaluation, the time lag for the adjustment of the money supply and prices to the new exchange rate was much longer. It lasted until 1960. This was due mainly to a stricter monetary and financial policy on the domestic scene. From 1960 to the present, prices in Mexico have remained fairly stable.

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Having briefly mentioned the course of events which led to Mexico's devaluations, and planning to return to this subject later, I should now like to offer some remarks of a general nature.

Inflationary pressures on countries in process of development are much more persistent and strong than those exerted on developed countries. As is to be expected, the capacity to form voluntary savings as well as to pay taxes is much less, and methods used to collect the latter are less effective. On the other hand, financial needs are proportionately much greater.

With the increase in social responsibilities in the modern state, the most difficult pressures for the monetary authorities to resist are those that come from the public sector. It is well known that at the stage of development that Professor W. W. Rostow calls "preconditions to take-off," investment of overhead capital is required which, because of its very nature, can only be carried out by the government. Such is the case with large irrigation projects, railroads, highways, port facilities, potable water, sewage and other urban facilities, as well as, in most under-developed countries, electric power, telecommunications, hospitals, schools, markets and low-cost housing.

It is understandable, because it is natural and human, that government officials in charge of solving these urgent needs want to make as much progress as possible in their respective fields during their terms of office—even at the cost of hindering other departments of the administration or causing budgetary deficits that may induce inflation. This, as some outstanding statesman have expressed it, amounts to a cruel tax levied on those segments of the population least able to endure it.

Moreover, it is very difficult for Ministers of Finance to convince other ministers in the government that the most effective way to betray their noble cause is through uncontrolled spending, and that, in the long run, monetary stability—the product of disciplined spending—provides many more real resources to solve the problems of infrastructure, education, health, and economic activity in general. A country benefits more from balanced and sustained growth than from spectacular but short-lived rates of development in any of the individual activities in any particular period of administration. Short-lived because, faced with rising prices brought about by monetary expansion, the government may be forced eventually to cut investments.

Monetary authorities must also struggle with the deficits of certain government-controlled enterprises. Because of easy access to public funds, government enterprises are frequently lax in their efforts to reduce costs and operate efficiently. The resulting deficits of the public sector have to be financed by the central bank, which, more often than not, is unable to offset this financing through open market operations, since genuine savings in sufficient amounts for a capital or money market to absorb these deficits do not always exist in developing countries.

But the private sector also creates strong inflationary pressures which are exerted mainly on the central bank. This is not only true of an important part of the industrial, agricultural and commercial sectors but also of the banking sector itself. Some private bankers believe that through the elimination or loosening of some legal reserve requirements or through unlimited rediscounts, the central bank should provide the banking system with abundant, cheap and opportune credit for all economic activities. These pressure groups frequently allege that "credit to increase production is not inflationary," or that "the central bank's stabilization policies slow down the country's progress." And there are countless plans to establish banks for the granting of loans to specific economic activities. They overlook the fact that—in the absence of developed money markets—if these banks do not obtain sufficient deposits from the public, it is the central bank that is resorted to in demand of rediscount. The stand taken by the central bank is that what is lacking is voluntary savings for the granting of more credit, not more banks.

Every day new solutions are offered to real or imaginary problems. Some favor the suppressing of taxes, other the granting of subsidies, still others want both. At the same time, it is thought that public investment should be increased in order to keep up economic activity and raise the country's productive capacity. In addition, there is constant pressure on the central bank of the country to back different types of low-interest loans on the grounds that entrepreneurs are not in a position to pay the high rates of interest prevailing on the market.

The Keynesian theory is often partially invoked in order to exert pressure on the monetary authorities. Although Lord Keynes said that speculation may do no harm when it consists of bubbles in a stream of new productive enterprises, he also said that the situation may become very serious when productive enterprises turn into bubbles in a whirlpool of speculation. This is precisely what is produced with head-on inflation. And the greatest loss, I believe, is not the ill-deserved gains speculators achieve at the cost of the public but the distortion of values that accompanies inflation. Resources and talent which otherwise would be used for the establishment or enlargement of productive enterprises are devoted to the wasteful activity of speculation.

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Let us now return to Mexico to examine the years following the devaluation of 1954. The strong unfavorable reaction of all sectors to the devaluation gave the Ministry of Finance and the Bank of Mexico sufficient strength successfully to overcome inflationary forces. With 1955, 1956 and the first half of 1957 being especially prosperous years in world economic activity, the Bank of Mexico recovered its reserve and has brought it to a point which, at present, is the highest in its history. This fact, along with the determination of the government to maintain the international parity of the peso at all costs and preserve absolute freedom of exchange, has inspired confidence on the part of domestic and foreign investors. The formation of internal savings has grown rapidly, and the government has been able to accelerate its rate of investment in urgently needed infrastructure projects. This has been possible due to the increase in fiscal revenue and in financing originating from voluntary internal savings and resources from abroad.

Since 1954, we have been able to face several recessions without the need to resort to devaluation and have used the monetary reserve as a buffer. I am thinking especially of 1961 and 1962. During these years, the Caribbean situation became critical and Mexico underwent strong exchange pressures. In spite of this, we were able to hold up with our own reserve, plus the decided support of the International Monetary

Fund and a supplementary credit from the Eximbank, which allowed us to keep our imports of capital goods at a high level. Both domestic and foreign investors regained confidence in Mexico in 1963 and 1964. This resurgence of faith and security and, therefore, of economic activity, is due mainly to the fact that the expenses of the public sector are adjusted to its budgetary possibilities and to its external and internal financial capacity which has increased considerably primarily because of exchange stability. Government income has risen sharply, and public investment such as roads, irrigation projects, electrification, etc., has been increasingly stepped up, as well as private investment in agriculture, industry and services.

These facts can be illustrated with the following figures that cover the decade in which the present rate of exchange has prevailed: the storage capacity of dams has increased 90%[1]; the installed generating capacity in electric power has risen 149%[2]; and the length of highways, 124%[3]. Since population rose 35% in the same period, Mexico has achieved through stabilization a substantial increase in the basic productive equipment available per person. These facilities have spurred additional private investments. Gross fixed investment during the 10-year period grew at an average annual rate of 6.3%[4] at constant prices.

Total bank financing to the private sector has also risen at a considerable rate, with an annual average of 17% at current prices since 1954. We are rapidly approaching the ideal in this sector—that is, credit which is opportune, reasonably abundant and cheap for all economic activities. The banking system now has an important volume of resources to lend and it is seeking solvent entrepreneurs with good projects in which to employ these funds. Under these circumstances, we expect the rate of interest, which has been traditionally high, to continue its recent moderate downward trend.

Mexico's case bears out the proposition that a well-conceived social and economic strategy for development, implemented by means of well-integrated programs, is the basis for stable growth, but also that more

[1] From 7.42 billion cubic meters in 1953 to 14.116 billion cubic meters in 1963.

[2] From 1.701 million kilowatts in 1953 to 4.243 million kilowatts in 1963.

[3] From 25,288 kilometers in 1953 to 56,586 kilometers in 1963.

[4] From 13.4 billion pesos in 1953 to 24.8 billion in 1963, at 1960 prices. During the same period, pig iron production increased 314%, rising from 242,000 tons in 1953 to 1,003,000 in 1963. Steel production rose 285%—from 525,000 tons in 1953 to 2,020,000 in 1963, and industrial and manufacturing production indexes doubled.

public and private investment can be completed and more credit can be granted through a system of disciplined budget and credit practices that prevents inflation, than by giving in to pressures that consider inflation to be the only way to advance development. It is clear that exchange stability in itself is not enough to foster economic progress, but it is also clear that, without the former, the latter is so difficult that it is valid to consider stability as an indispensable element in achieving progress. It should be noted also that wage improvements, essential in broadening the market for industrial growth and in reducing social inequality, become meaningless unless relative price stability can be achieved.

It is true that Mexico has enjoyed conditions particularly favorable to stabilization, but it is also true that we have known how to take advantage of them. The country has scrupulously paid all its foreign debts on time; long-standing debts of more than a century, that were renegotiated, have been met ahead of schedule and are practically paid off. And, due to the central bank's constant vigilance and support when needed, not one credit institution in the country has gone bankrupt in the last quarter of a century nor been liquidated without full payment to its depositors.

It is hoped that in 1964, despite its having been a year of elections and change of administration, the increase in the gross national product will exceed 7%. The strong position of our own reserve, and the additional reserves the Bank of Mexico has in international institutions, untouched as yet, lead us to believe that, unless a catastrophe takes place, Mexico will continue to enjoy monetary stability. It may be predicted that the next administration, from 1964 to 1970, will be one of rapid economic development, and that wide-scale social and cultural betterment of the Mexican people will be fostered. A steady, long-term increase in real income and productivity is a strong equalizing force, and one that, in expanding the middle class, stimulates the formation of voluntary savings. Such savings may be invested directly or through the purchase of stock, or in buying fixed-rate securities or placing interest-producing deposits with financial institutions. These trends combine to finance the constructive activity of efficient entrepreneurs.

* * * *

Gentlemen, I am grateful for the honor of speaking before an institution dedicated to the memory of our unforgettable friend, Per Jacobsson. In relating the experience of Mexico, a country in full process of development, you have no doubt realized that the policies successfully put into practice by our monetary and credit authorities coincide with those that Per Jacobsson himself spread with such vigor and enthusiasm. Your invitation has given me the opportunity once more of expressing my conviction that the contribution this great international financier has made to world monetary order has been one of exceptional value. There is no doubt that Ministers of Finance and directors of central banks throughout the world have invoked his high moral and technical authority in dealing with inflationary pressures. In so doing, their purpose has been to keep within the course set by the healthy and orderly policies advocated by Per Jacobsson—policies which have so greatly aided in raising the standard of living in the countries that have adopted them.

CONCLUDING REMARKS

by

AMBASSADOR BURGESS

LADIES and gentlemen, I am sure you will all agree that Don Rodrigo Gómez has told us, very modestly, a story of great importance, of how a developing country can, through the ins and outs of a difficult period, find its way to monetary stability, and can combine economic growth with stability, to the great advantage of the former. We are very greatly obliged to you, sir, for coming here and giving us this very important parallel lesson to that presented to us by Maurice Frère.

The hour is getting on. I think perhaps it would be wise to assume that the question period will be conducted in private.

This has been a worthwhile beginning of our program of Per Jacobsson Foundation Lectures which, we hope, will go on for many years and will grow in importance. Whether it does depends on whether you make it so: whether the people engaged in finance and central banking believe that this program is important enough to support with such fine attendance as this today, and whether we can find other speakers who will give us comparable lessons which will be valuable for the world.

Mrs. Jacobsson has asked me to thank everybody here, on her behalf and on behalf of the family, for your friendship and great kindness in participating in this enterprise. I know we are all delighted to have the Jacobsson family here in such force; we know the work that Dr. Jucker-Fleetwood in particular is doing in carrying on the analysis of Per Jacobsson's papers, to make them available in the proper way at the proper time, with the University helping her. So that in this way, too, the work of Per Jacobsson will be carried on, as it will be with this Foundation.

This meeting is adjourned until next autumn, in 1965, when we will meet again in Washington, at the time of the Annual Meeting of the International Monetary Fund and the World Bank.

Appendices

BIOGRAPHY OF MAURICE FRERE

MAURICE FRERE began his association with international financial and monetary affairs as a Director in the Belgian Ministry of Economic Affairs at the age of twenty-eight, at the end of the 1914-18 war. He continued to serve his government in this area of work for another twenty years, first as a Director in the Reparation Commission, as Economic Counsellor in the Berlin Transfer Commtitee under the Dawes Plan, as Financial Counsellor in the Belgian Legation in Berlin. From 1932 to 1937 he was League of Nations Counsellor at the Austrian National Bank, in Vienna.

In 1938 Mr. Frère became Chairman of the Banking Commission for Control of Banks and Public Issues. He was, at the same time, Lecturer at Brussels University and is today a Permanent Member of the Board of Brussels University.

In 1944 he was chosen as Governor of the National Bank of Belgium and remained in this office until his retirement from the Bank in 1957. Also in 1944 he became a member of the Board of the Bank for International Settlements and he continues to serve in that capacity today. He was made Chairman of that Board and President of the Bank for International Settlements in 1946, and retained this post until his retirement from public life.

From 1946 to 1957 he served as a Governor of the International Monetary Fund and as an Alternate Governor of the International Bank for Reconstruction and Development.

In October 1957, following his retirement from the National Bank, Mr. Frère became Chairman of the Board and President of the Permanent Committee of SOFINA—Société Financière de Transports et d'Entreprises Industrielles of Brussels.

Mr. Frère, who was born on 8 August 1890, was educated at Brussels University and served there as an Assistant for two years. He now makes his home in Brussels.

BIOGRAPHY OF RODRIGO GOMEZ

RODRIGO GÓMEZ has, for most of his life, been directly concerned with banking and monetary matters, but before entering banking as a profession was active in industrial enterprises in his native country. His first banking associations were with private banks in Monterrey and other cities in Mexico, specializing in the field of foreign exchange banking.

In 1933, at the age of 36, he began his association with the Bank of Mexico, a career which has lasted now for over 30 years. His first task with the Bank was the establishing of a fixed exchange rate for the peso. His present position of Director General of the Bank of Mexico dates from December of 1952.

Mr. Gómez has been called on to represent his country's interests in a number of international activities connected with the field of work to which his career has been devoted. He represented Mexico at the Bretton Woods Conference in 1944 where the International Monetary Fund was formed and served on the Board of Governors of that institution from the time of its establishment. He has handled financial matters on behalf of his Government with authorities in the United States, Spain, Italy and Saudi Arabia and in many countries of Latin America.

At the international level, Mr. Gómez has often been called to serve the interests of the Latin American nations in financial and monetary affairs.

Currently he is a member of the Inter-American Committee of the Alliance for Progress and in 1962 was a member of a committee of the Organization of American States formed to evaluate Chile's National Programme for Economic and Social Development. Mr. Gómez participated in 1958 and 1959 in studying the UN proposals for a Latin American Common Market. And on two occasions, in 1946-48 and again in 1958-60, Mr. Gómez was elected by a group of Latin American countries to represent them on the Board of Executive Directors of the International Monetary Fund.

Mr. Gómez who was born 18 May 1897, now makes his home in Mexico City.

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