THREATS To the Dollar

The dollar was threatened on two fronts, foreign and domestic, during the past few months. One threat to its international position was first posed by the devaluation of sterling, later by a much worsened balance-of-payments deficit, and then, by the gold crisis. The other was the continuing internal decline in the dollar's purchasing power. Though less dramatic than the external developments, its dangers were no less real. Monetary policymakers went to work on both problems. After following a policy of monetary stimulus for more than a year, the Federal Reserve began to firm credit conditions in late 1967.

Once the Federal Reserve changed its posture, it quickly used all of its traditional policy instruments. On November 19, the Board of Governors announced approval of actions by Federal Reserve Banks to increase their discount rate, or interest charged member banks for borrowing, from 4 to 4½ percent. By mid-December, financial markets began to sense a reduction in the rate at which reserves were supplied through open market operations. And if any doubt of a policy shift away from monetary stimulus remained, it was removed on December 27 by the increase in member bank reserve requirements.

In a sense, the hike in the discount rate last November was not so much a move to tighten domestic credit as a reaction to the British devaluation. The devaluation, disturbing to international financial stability, was widely expected to induce an attack on the dollar. To assure confidence, a dramatic response seemed necessary. The discount rate rise, followed by increases in U.S. short-term rates, filled this need and served as a precaution against speculative outflows. The 4-percent discount rate was becoming out of line with market yields on short-term instruments.

Later, on December 12, the Federal Open Market Committee decided that open market operations should be changed to achieve somewhat firmer monetary conditions. During the Committee's discussion various members also favored early consideration of an increase in member bank reserve requirements.

The Board of Governors took this further step in a gradual firming of monetary policy just before year-end. Reserve requirements against demand deposits in excess of $5 million were raised for reserve city banks from 16½ to 17 percent, effective January 11, and for other member banks from 12 to 12½ percent, beginning January 18.

Monthly Review, Vol. LIII, No. 4. Free subscription and additional copies available upon request to the Research Department, Federal Reserve Bank of Atlanta, Atlanta, Georgia 30303.

This action increased required reserves of member banks by $550 million.

No one could mistake why this was done. The Board's press statement itself alluded to inflationary pressures and disequilibrium in the balance of payments.

Almost the same words were used in the announcement of March 14, when the Board of Governors, with the rush on gold in the background, approved increases in the discount rate to 5 percent. Its purpose was to "strengthen the international position of the dollar and to curb inflationary pressures in the domestic economy."

The Domestic Inflation Problem

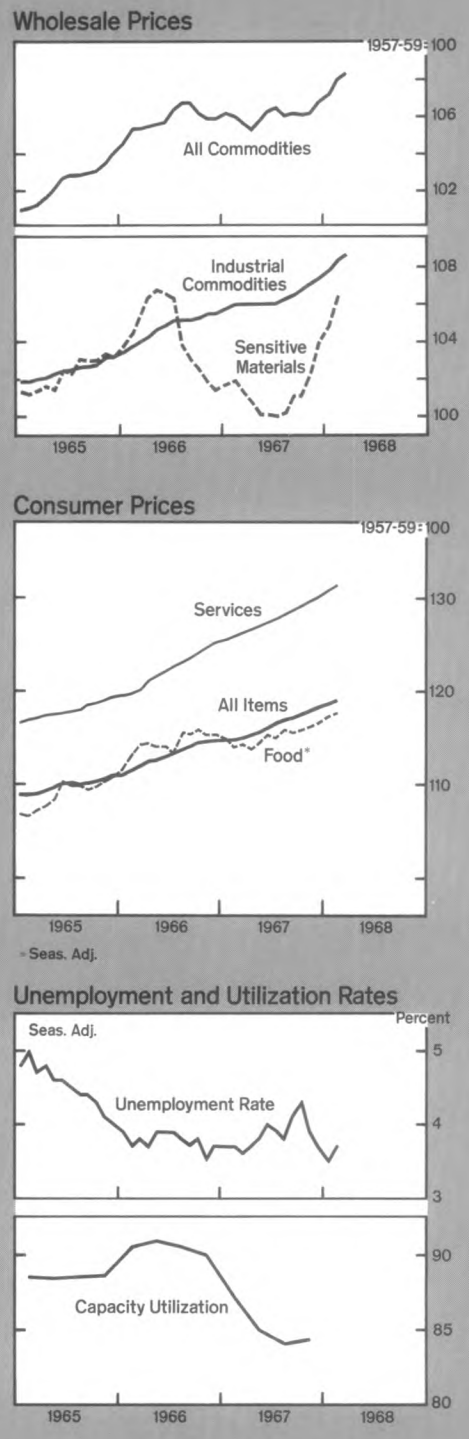
The threat to price stability in 1967 emerged gradually. In the first half, inflationary pressures were not serious; their intensification later could not be ignored. The "all commodities" wholesale price index, for example, fluctuated in a narrow range from autumn 1966 to autumn 1967. But it jumped sharply in subsequent months and in March was 2 percent above November's level.

Price pressures have been most marked for industrial commodities. These prices, which had been virtually stable in the first half of 1967, began to climb once more during the summer and have gone up at an annual rate of about 4 percent since October.

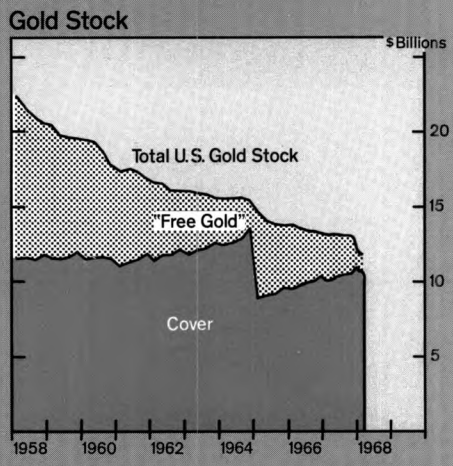
The behavior of consumer prices gave additional indications of rising inflationary pressures. After showing little change in the previous six months, the "all items" index, between March 1967 and February 1968, rose at an annual rate of 3¾ percent. Food prices—whose decline was largely responsible for the stability in the overall index in late 1966 and early 1967—turned up and later contributed significantly to the advance in consumer prices, as did also large increases in prices of other commodities. The chief culprit, though, has been the cost of services. Rising at an annual rate of 2.7 percent a year even in 1965, service prices have increased at a 4.3-percent annual rate since March 1967 and at a rate of nearly 5 percent since last autumn.

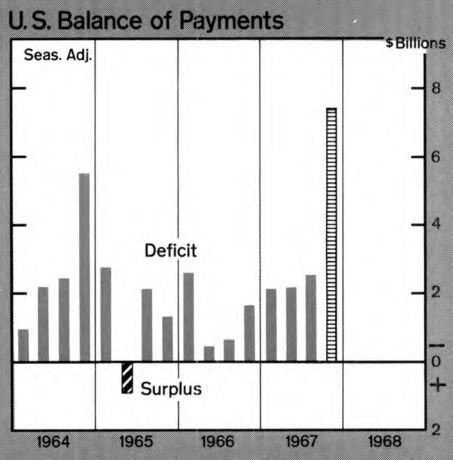
This strong upward price movement was fueled from both supply and demand forces. Unit labor costs in manufacturing exerted upward pressure on prices, as wages rose faster than output per man-hour. With manpower needs large, the unemployment rate fell quickly to 3.7 percent in December, after climbing from 3.8 percent to 4.3 percent between August and October because of strikes. Unemployment during January and February 1968 stayed in the 3.5- to 3.7-percent range, the lowest in years. Labor markets have been particularly tight for skilled workers.

Inflationary pressures, measured by the behavior of wholesale prices, began to intensify in the fall of 1967. Consumer prices have also accelerated because of increased demands and higher costs, as resources (especially for labor) turned scarcer.



The gold crisis caused further heavy losses in our gold stock, all of which is now available to meet our international commitments. The sudden deterioration in our balance-of-payments position in late 1967 partly reflects a worsening in the trade surplus.





Unused manufacturing capacity is still quite large because of very high expenditures on new plant and equipment and relatively little growth in manufacturing output since late 1966. Nevertheless, some industries—notably steel, textile, and capital equipment firms—are currently feeling serious capacity pressures.

On the demand side, inventory building to an increasing extent has been superimposed on a steady growth in final sales. Consequently, the classical, cumulative process of declining inventory accumulation, decreasing production, falling income, and reduced sales did not have a chance to develop, and the contraction in inventory investment during 1967 was limited to two quarters. The marked pick-up in inventory investment during the second half of the year gave strong support to economic activity. Stockpiling of steel against a possible strike after the contract expiration this coming July has been particularly heavy.

Financial Developments

Rising steel and automobile inventories prompted heavier borrowings among these related product firms in late 1967 and early 1968. Yet most other industries borrowed only modest amounts from banks, as corporate Treasurers seemed more willing to issue bonds, especially in the last half of 1967.

With the Federal budget continuing in substantial deficit, the U.S. Treasury was another heavy borrower. In part because of the pause in industrial activity last year, tax receipts in 1967 failed to grow as much as in previous years. This sluggishness, together with a sharp rise in expenditures, resulted in the huge quarterly cash deficit of $4.9 billion in the third quarter. The fourth quarter deficit of $4.5 billion was almost as large, and no respite from additional deficit financing lies ahead. The President's budget, presented to Congress in January, forecasts a deficit of $8 billion on the new unified budget basis for fiscal year 1969. This figure assumes passage of the 10-percent surcharge on personal and corporate tax payments, the renewal of excise taxes, and an acceleration of corporate income tax collections. It makes no allowance for more troops slated for Vietnam.

International Developments

Besides domestic considerations, the change in monetary policy last year was prompted also by two dramatic events in our economic relations with other countries. The first was the British devaluation; the second, the sudden deterioration in the U.S. balance of payments.

The change in the parity of the pound unleashed strong fears about the dollar. As a result, private individuals abroad and some small central banks bought gold in two massive waves. In support of the official $35 per ounce price of gold, the Gold Pool—comprised of the United States, United Kingdom, Germany, Italy, Belgium, the Netherlands, and Switzerland—sold vast sums of gold in the London market. As a member of the Gold Pool, the United States had to share in these losses. We can surmise how large these were by the $900-million drop in our gold stock in December and $62-million decline in January.

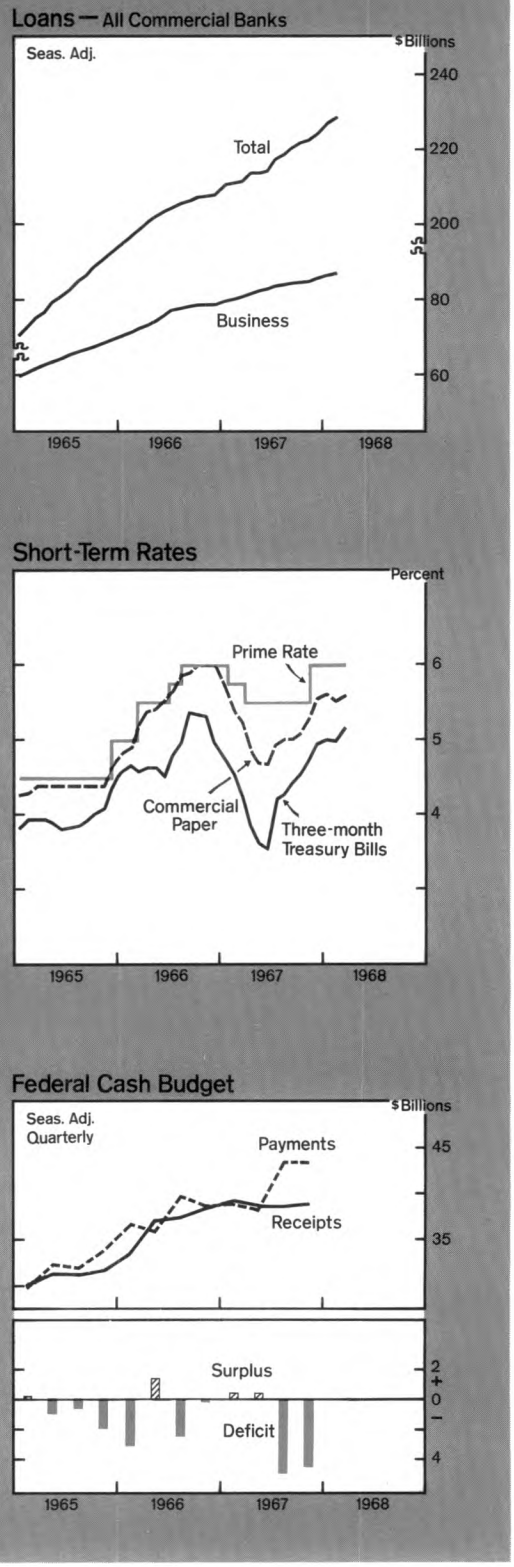
A third wave of gold buying in March was triggered by speculation about a possible change in U.S. gold policy. It culminated in the temporary closing of the London gold market on March 15 and a decision by Gold Pool members to cease Gold Pool operations and henceforth deal in gold only with governments. Here again, the costs to our gold stock through the operations of the Gold Pool, although exceedingly heavy, are not fully known. However, the U.S. Treasury gold holdings declined by $1.4 billion in March, because of transfers to the Exchange Stabilization Fund. With gold reserve requirements against Federal Reserve notes recently repealed, there is now no question that all of our remaining gold stock is available to meet international commitments.

Although the speculative attack on the dollar was contained, our balance of payments worsened significantly, particularly in the fourth quarter of last year. The estimated deficit for 1967, one of the highest since the end of World War II, approaches the very serious level of 1960. This rather sudden increase led the President to announce on January 1 a drastic new program for reducing the deficit in 1968. The move to a somewhat firmer monetary policy was also intended to help reduce the deficit. And to the extent that cooperation among central banks through the swap network and other means calmed the exchange markets, the strength of the dollar was also maintained. But all of these measures did no more than buy time to attain equilibrium in the overall U.S. payments position.

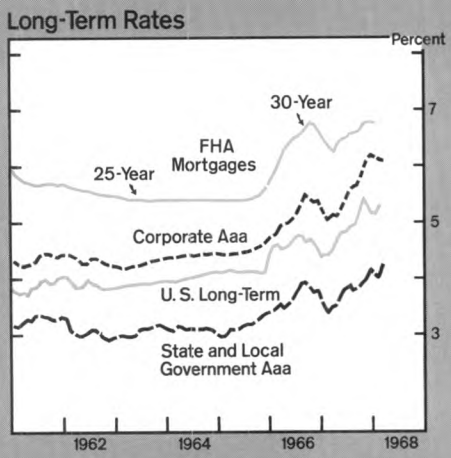
Impact of Policy Shift

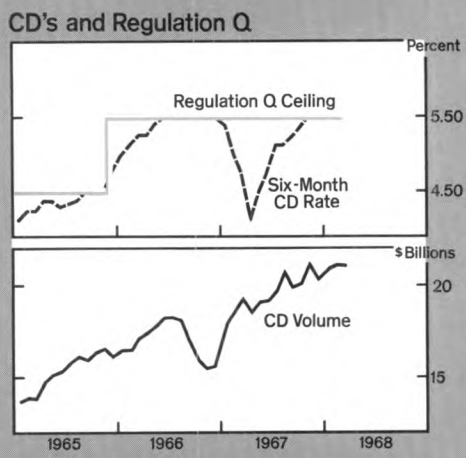
Although it is too early to assess the effects of the monetary policy shift on prices or international transactions, its impact on certain financial variables is already discernible. Member banks responded to the closer rationing of reserves by trimming excess reserves and borrowing more heavily from Federal Reserve Banks. Such borrowings, averaging $133 million in November,

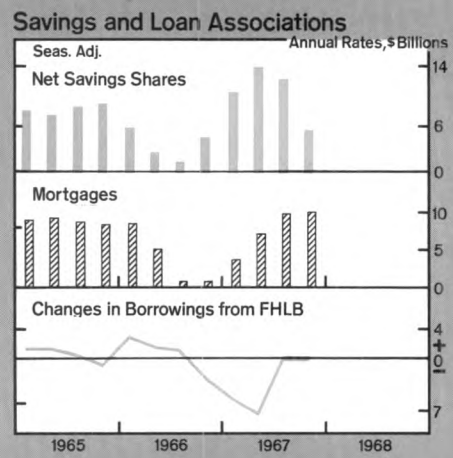
Although bank loan demands are relatively moderate and monetary policy until late 1967 easy, short-term interest rates have expanded rapidly since mid-1967. Heavy Federal deficit financing is part of the explanation.



Long-term interest rates also advanced substantially before the shift in monetary policy. With rates on negotiable certificates of deposit reaching the ceiling, the inflow of this source of funds has slowed down, as has the flow of funds to savings and loan associations.







climbed to almost $800 million in mid-March.

The turn in monetary policy also caused an immediate rise in short-term rates, which had already climbed sharply by the time of the discount rate hike in November. In early 1968, upward pressures on these rates lessened, but increased beginning in early March. Long-term borrowing costs which, except for mortgages, also fell in early 1968 in partial response to the payments program, rose during March.

With loan demand remaining fairly moderate, many banks have neither experienced great pressures on their liquidity position nor felt a precipitous drop in deposits. Demand deposits increased in January, held unchanged in February, and advanced in March. Time deposits have also continued to expand so far this year, though more slowly than last autumn. With short rates rising, many banks, however, have no leeway under Regulation Q ceilings to attract large inflows of corporate time deposits. Savings and loan associations are likewise finding it more difficult to garner savings, although their flow of funds in January and February was better than expected.

New Threats?

At the moment the threat to the dollar, from the international side at least, has subsided. Inflationary symptoms, on the other hand, are continuing.

Monetary policymakers can build defenses against both of these dangers. But since many domestic and international developments are not influenced directly by American monetary policy, the resolution of these problems rests heavily on other shoulders. Fiscal restraint, confidence abroad, and international cooperation will largely determine the answer—not U.S. monetary policy alone.

The Research Staff of the Federal Reserve Bank of Atlanta was responsible for this article.

Bank Announcements

The **Gwinnett Bank and Trust Company,** Norcross, Georgia, a new nonmember bank, opened on March 1 and began to remit at par for checks drawn on it when received from the Federal Reserve Bank. Officers are J. Grady Coleman, president; W. Leon Maloney, vice president; and Paul S. Penn, Jr., cashier. Capital is $250,000; surplus and other capital funds, $250,000.

The Exchange Bank of Springfield, Springfield, Georgia, a nonmember bank, also began to remit at par on March 1.

Another nonmember bank, **The Park Avenue Bank,** Valdosta, Georgia, began to remit at par on March 15.