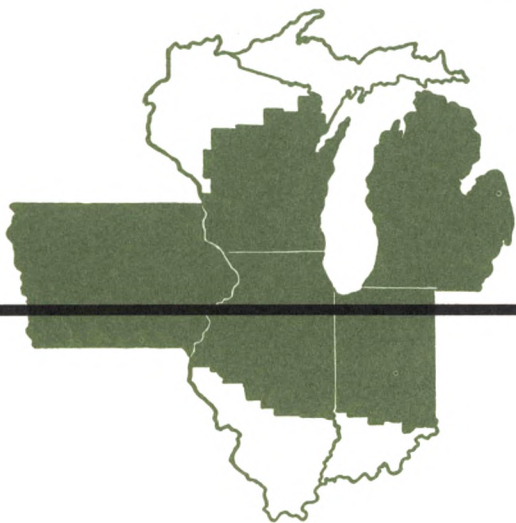


A review by the **Federal Reserve Bank of Chicago**

Business Conditions

1963 February



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THE Trend OF BUSINESS

Retail sales rose vigorously in the closing months of 1962 while employment and production continued at the levels that had prevailed during most of the summer and fall. If consumer purchases were to remain strong, as was the case in the early weeks of 1963, business inventories and spending for new plant and equipment might soon begin to rise, thereby reversing the recent declines in these sectors.

Developments have been sufficiently favorable to cause a revision in the widely accepted forecast of business activity some months ago which had hinted at a mild recession in the first half of 1963. Recently, the view expressed most commonly has called for a flat or mildly rising trend in the first half of the year followed by a stronger upswing in the second half, often predicated upon stimulation expected from a cut in Federal income taxes.

Capital expenditure plans strengthen

A mild decline in the rate of spending on new plant and equipment between the fourth quarter of 1962 and the first quarter of 1963 was indicated in a Government survey released in December. This has played an important role in current estimates of future business activity.

Declines in such outlays almost invariably have been accompanied by downturns in general business activity. However, there is evidence that capital expenditure plans have been raised by many business firms since the

survey mentioned above was taken. For example, the railroads had been expected to reduce their capital outlays 12 per cent in 1963. A more recent survey by *Railway Age* indicates an increase of 20 per cent. The petroleum industry had been expected to reduce outlays 13 per cent in 1963, but industry sources now anticipate that outlays will be maintained at last year's level.

Plans also appear to have been revised upward in the textile, automotive and steel industries. While capital outlays in steel were indicated to rise 13 per cent in 1963, the largest gain for any major industry, a number of projects announced since that time suggest an even greater rise. In the Chicago area virtually all of the producers have reported plans for important new facilities, and Bethlehem has stated that work soon will begin on its first midwestern plant at Burns Ditch, Indiana.

Although there is evidence of large amounts of "excess capacity" in the steel industry, new facilities often are designed to produce new products or to achieve substantially lower costs. For example, most steel companies are contemplating the installation of oxygen converters to take the place of open hearth furnaces in the production of steel ingots. These converters have much lower initial capital investment per ton of capacity and somewhat lower operating costs than existing facilities. The smaller batches of steel produced in these units permits greater flexibility in scheduling output than has been

possible with the open hearths. Meanwhile, finishing capacity is being expanded rapidly for a number of steel products, especially "thin tin" plate which competes with other materials in the lightweight can market. Existing mills are not capable of rolling the new product.

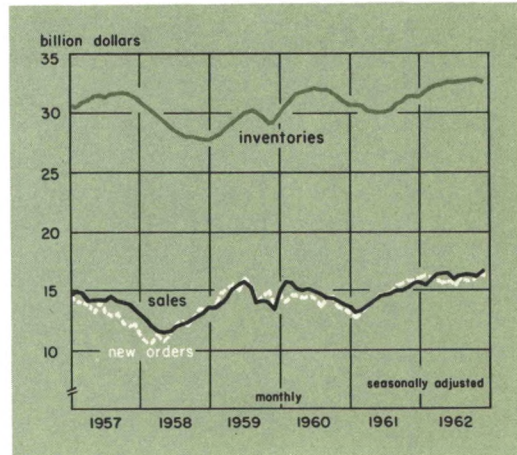
Buyers and sellers of capital goods have shown growing interest in the tax credit which lowers the cost of certain types of new equipment as much as 7 per cent and the more liberal depreciation guidelines which may be used in calculating income tax liabilities for 1962 and subsequent years. Both of these programs increase the profit potential to be expected from new capital goods by reducing or postponing tax liabilities. It appears that a "second look" has caused many business firms to value these incentives more highly than was indicated earlier. The combination of the tax credit and more rapid depreciation is credited with much of the increase in capital expenditures now indicated in the railroad industry.

However, tax credits and accelerated depreciation work "on the margin", by reducing capital costs and increasing cash flow, and can do little to encourage capital outlays which do not appear advantageous on other grounds. New capital goods are purchased in the expectation that they will increase profits by creating capacity to produce new products, cutting operating costs, improving quality and in some instances expanding capacity to produce existing products. The programs will be most effective in an atmosphere of confidence based upon rising sales and order backlogs.

Inventory growth slows

Business inventories may have a more important impact upon total activity in the months immediately ahead than any changes in plant and equipment outlays. In the second

Durable goods manufacturers' new orders edged above sales in late 1962 after lagging most of the year



half of 1962, business inventories increased very little despite rising sales and according to most estimates are low relative to current sales. Important swings in the United States economy during the past decade usually have been accompanied by substantial changes in inventories.

At the end of November the book value of total business inventories was 3.5 per cent higher than a year earlier. Over the same period total business sales had increased 5.1 per cent. As a result, the ratio of inventories to sales declined to the lowest level since the spring of 1959.

Sluggish sales during the past spring and summer help explain the slow rise of inventories. This trend was aided also by the ample capacity in virtually all lines, the absence of expectations of price increases and a reduction in the proportion of production represented by military and industrial equipment with a long "lead time" between order and delivery.

At the end of 1962 steel inventories were "back to normal" and in some cases, extremely low, according to some analysts. Steel production was at an annual rate of just under 100 million tons and was believed to be close to consumption. But the outlook is complicated by the possibility of a strike. Under the terms of the labor-management contract, wage negotiations can be reopened May 1 and a work stoppage could be called for August 1. Some steel consumers already are making plans to increase their stocks in the months ahead. Steel buyers have been told to "stay on top of your suppliers' situation and required lead times for your products." In early January the majority of fabricators contacted by *Iron Age* planned to increase steel inventories 50 to 100 per cent above "normal" in the months ahead.

A great deal has been done to improve inventory management in most industries in recent years through the use of computers, air transport and other techniques. Nevertheless, it is apparent that a sharp rise in orders could upset plans based upon very rapid deliveries from suppliers. In this case inventory accumulation to assure uninterrupted production schedules and adequate supplies at retail could become once again the most expansionary force in the economy.

The biggest Christmas ever

Normally about 28 per cent of a year's retail sales occur in the fourth quarter, more than in any other quarter. This reflects, of course, the influence of Christmas buying. Stores which emphasize gift merchandise may make a third or more of their sales in the fourth quarter. For many of these merchants the margin of profit or loss for the year is largely determined by holiday trade.

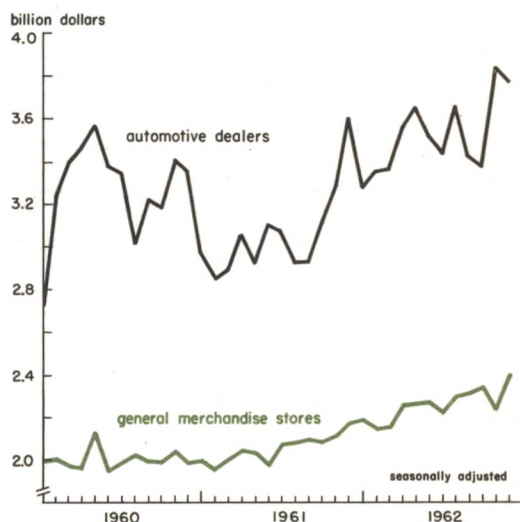
Total retail sales in the fourth quarter of 1962 were at a record annual rate of over

240 billion dollars. Sales of auto dealers increased sharply between the third and fourth quarters while sales of other stores rose slightly, seasonally adjusted, as shown in the following table:

	Third quarter 1962 to fourth quarter 1962	Fourth quarter 1961 to fourth quarter 1962
	(per cent increase)	
Auto dealers . .	8.2	11.4
Other stores . .	0.8	5.4
Total retail . .	2.2	6.5

In the four weeks ending December 29, which included the bulk of the Christmas trade, department store sales in the nation were 5 per cent above the record 1961 period. For the Seventh Federal Reserve District the gain was 8 per cent with increases ranging from 4 per cent in Indianapolis and Milwaukee to 12 per cent for the Chicago area.

Sales of auto dealers and general merchandise stores led the rise in retail trade in fourth quarter



The strong trend in auto sales in the fourth quarter brought the total number of new cars sold to American purchasers last year to 7.1 million including imports—a level projected only by the most optimistic forecasts at the start of the year. This number was 19 per cent above the 1961 total and was exceeded only in 1955. In dollar terms, car sales were substantially above any previous year as the rise in sales was accompanied by a trend toward larger, more powerful and more elaborately equipped cars.

Consumers have recently increased their use of instalment credit as their purchases of durables have risen. The November expansion in such credit outstanding—almost 600 million dollars, seasonally adjusted—was the largest since 1959. Extensions of credit amounted to almost 5 billion dollars, the highest on record. Automobile paper accounted for 36 per cent of the extensions of instalment credit during November and 41 per cent of the outstandings at the end of the month. During 1962, 59 per cent of all new cars purchased were financed, about the same as in 1961, but a smaller proportion than in

any of the years in the 1955-60 period.

While consumer expenditures have shown greater strength in recent months, Government purchases of goods and services continued to rise steadily and current estimates indicate that this trend will continue in 1963. These developments have encouraged a spirit of optimism among many business groups which contrasts with the cold weather “blues” often characteristic of the early weeks of a new year. Substantial gains in business have been forecast by polls of purchasing agents, construction contractors and manufacturers of appliances, carpets and furniture. Producers of autos and TV expect, at worst, mild reductions from the high levels of 1962.

Views of businessmen can shift markedly in short periods of time. Last year optimism early in the year gave way to bearishness in the summer and early fall. The recent surge in confidence, of course, can melt away if incoming business proves disappointing. However, for the period immediately ahead business decisions apparently will be made in an atmosphere much improved from that which prevailed a few months ago.

Trends in banking and finance

Negotiable time certificates of deposit

The sharp rise in time and savings deposits was probably the outstanding development in commercial banking in 1962. At the end of the year, these deposits at commercial banks totaled 97 billion dollars, almost 20 per cent higher than at the end of 1961. Furthermore,

the increase was the greatest for any year in the postwar period. The rise was sharpest at large banks in major cities with the weekly reporting banks in Chicago, for example, showing an increase of almost 30 per cent.

Among the various types of time deposit

services offered by banks, time certificates of deposit in denominations of 100,000 dollars or over expanded most rapidly. These certificates, popularly known as CDs, are generally in negotiable form and readily marketable, enabling them to be sold at any time. They are, of course, redeemable upon maturity at the banks issuing them.

Over 800 million dollars of these large certificates of deposit were outstanding at Seventh District banks at the end of 1962, more than twice the volume at the end of the preceding year. Large New York City banks experienced a similar rate of growth and had about 1.8 billion dollars in these CDs outstanding.

Development of secondary market

The very rapid expansion of CDs in 1962 is attributed both to the increase in interest rates offered by banks and the development of a secondary market in these certificates.

CDs are not new; some banks have issued them for many years. Before 1961, however, they were traded infrequently since there was no organized secondary market. This meant that depositors were unable to reacquire their funds prior to the maturity date. The volume of funds available for investment in CDs under these conditions was quite limited.

In order to gain greater access to the vast national market for short-term funds, a large New York City bank arranged in early 1961 for a Government securities dealer to provide a market for the certificates issued by the bank. Soon afterward other large banks stepped up their sales of CDs and more dealers commenced trading in them. The development of a viable secondary market for CDs substantially altered the nature of the certificates.

On the one hand, depositors could now obtain the use of their time deposits at any

time by selling their certificates. The breadth of the market along with the short maturity of most CDs assured depositors that certificates could be sold at any time for approximately their face value thereby giving them many of the characteristics of such short-term money market instruments as Treasury bills, commercial paper and bankers acceptances, and were soon accepted as such by an increasing number of investors.

CD—a sample certificate

On the other hand, the broadened market enabled banks to tap the vast national pool of short-term funds much more effectively. Possibly the most revolutionary feature of CDs is that for the first time banks were able to compete for funds on an equal footing with other borrowers, limited only by creditworthiness and their willingness and ability to pay for the funds.¹

Prior to 1961, banks were generally able to attract additional deposits from large business firms only by entering into loan agreements. Banks whose service areas were limited to a particular metropolitan area or region were further restricted in their quest

¹While individual banks can increase deposits in this way, all banks cannot do so simultaneously. Expansion of total bank deposits is limited by the volume of reserves provided by the Federal Reserve System and the legal reserve requirements on deposits set by the System.

for additional deposits by geographical considerations. Since 1961, with the development of an active secondary market for CDs, any bank which has a national reputation can bid for deposits from any part of the country and without an accompanying obligation to extend loans concurrently.

Although holders of CDs can sell them at any time, the bank retains the deposit at least until the stated maturity date. Thus, while the development of the secondary market effectively removed the maturity date for depositors, it did not alter the length of time banks have the use of the funds.

Favorable for large banks

Interest rates on CDs, like those on other money market instruments, are determined in part by the size and financial reputation of the issuing bank. Therefore, interest rates tend to be lower on certificates issued by large and well-known banks than on those issued by smaller or less widely known banks. This is the case with respect to both the rate stated on the CD at time of issue and the yield at which the certificates sell in the secondary market.

Certificates issued by only two banks with deposits of less than 100 million dollars and 12 banks with deposits of less than 500 million have appeared on the semi-weekly quote sheet issued by one of the leading dealers. These sheets list the amounts and effective yields of CDs offered for sale by the dealer according to issuing bank. In all, CDs issued by 36 different banks have been listed by this dealer during 1962. Those issued by smaller banks have been priced to yield a premium of up to 2/10 of a per cent over yields

on certificates of comparable maturities issued by a few of the country's most prominent banks.

The standard unit of trade in CDs is 1 million dollars and multiples thereof. This also tends to orient the market toward certificates issued by large banks whose financial strength enables them to accommodate the higher denominations. A limited volume of transactions is conducted in denominations of less than 1 million dollars, mostly 500,000 dollars and on occasion as small as 100,000, but these are not common and the certificates sell at lower prices (higher yields).

Because of the financial strength and reputation of large money market banks, CDs issued by them yield only slightly higher rates than Treasury bills—the money market instrument generally considered to have the least risk of default and to be the most readily marketable. The spread between interest yields on CDs issued by large banks and on Treasury bills of comparable maturities fluctuates between 2/10 and 4/10 of a per cent, widening as the time to maturity lengthens. Rates on CDs approximate those on prime

Most CDs have been issued by large banks in the District

Bank deposit size (millions)	Number of banks	CDs issued by denominations			
		\$100,000 - \$499,999		\$500,000 or over	
		Dollar amount (millions)	Number	Dollar amount (millions)	Number
Under \$100	10	15	103	11	13
\$100 - 200	7	16	101	20	20
\$200 - 500	6	19	136	111	116
Over \$500	9	71	418	555	664
Total	32	121	758	697	813

commercial paper and bankers acceptances.

Interest rates offered by banks on certificates, similar to rates offered by banks on most other types of time and savings deposits, are subject to control under Regulation Q.² Present regulations prohibit banks from offering rates higher than:

Deposit payable in:	Maximum interest rate (per cent)
30 - 89 days	1
90 days but under 6 months	2½
6 months but under 1 year	3½
1 year or more	4

These ceilings apply only to the interest rates paid by the banks, not the effective yields at which the certificates trade. While banks are prohibited from paying more than 2½ per cent on certificates maturing in less than six months, CDs with less than six months remaining to maturity currently trade at yields above that ceiling. This is possible because market yields have not declined very rapidly as the CDs approach maturity, and a CD issued at, say, 3¼ per cent for seven months may yield an effective rate of 3 per cent two months later.

CDs in the Seventh District

A recent survey of large Seventh District banks helps to round out the current picture. The banks were requested to report on their outstanding negotiable certificates of deposit in denominations of 100,000 dollars or larger. Of the 62 banks surveyed, 32 reported that they had such CDs outstanding on December 5, the survey date, in a total amount in excess of 800 million dollars. Twenty-two of

²In October 1962, time deposits of international agencies and foreign governments and central banks were excluded from interest rate ceilings for a period of three years.

these banks had issued certificates in denominations of 500,000 dollars or over.

Most CDs were issued by banks in the major District financial centers. Chicago and Detroit alone accounted for almost 90 per cent of the dollar volume. Other District cities with more than 5 million dollars in certificates outstanding included, in order of importance, Milwaukee, Grand Rapids, Flint, Bay City and Indianapolis. The relatively small volume reported by Indianapolis banks may be attributed in part to the 3 per cent interest rate ceiling on time deposits provided by state regulation in Indiana.

Business firms were the largest initial purchasers of CDs, having purchased 87 per cent of the amount outstanding on the survey date. State and political subdivisions were next, but accounted for only 7 per cent of the total.

Over 90 per cent of CDs outstanding were issued with maturities of between six and 12 months—only 7 per cent had maturities of over one year and 2 per cent, maturities under six months. Forty-seven per cent were issued with maturities of between six and nine months; 16 per cent, nine months to a year and 28 per cent, exactly one year. The

Banks in Illinois and Michigan have issued the greatest amounts of CDs*

	December 31, 1960	December 31, 1961	December 5, 1962
	(million dollars)		
Illinois . . .	2	258	552
Indiana . . .	4	5	6
Iowa . . .	0	0	1
Michigan . . .	17	40	211
Wisconsin . . .	4	28	48
Total . . .	27	331	818

*In denominations of \$100,000 or over.

negligible volume issued with maturities of less than six months is explained by the tendency during the past two years for the Treasury bill rate to fluctuate above the 2½ per cent interest rate ceiling that banks are permitted to offer for time deposits of less than six months.

While the larger banks accounted for a high proportion of the total volume of CDs outstanding, the proportion of their total time deposits in the form of CDs was no greater than the proportion for the smaller banks included in the survey. Five District banks had CDs outstanding in excess of 20 per cent of their total time deposits and these were of varying deposit size. Eleven banks, again of varying deposit size, held less than 5 per cent of their total time deposits in the form of CDs.

For all 32 banks, CDs accounted for 13 per cent of total time deposits and 54 per cent of time deposits excluding savings deposits.

In their brief period of existence, negotiable certificates of deposit have achieved an important place both in the deposits of commercial banks and as a money market instrument. Because they enable banks to effectively tap the national money market while providing investors with a highly regarded interest yielding liquid asset, the dollar amount of CDs outstanding may be expected to expand at a rapid pace until either banks no longer wish to attract additional deposits or market interest rates rise to a level where banks are effectively precluded by legal interest rate ceilings from offering competitive rates. Neither condition seems imminent.

Monetary policy and international payments

*William McChesney Martin, Jr., Chairman,
Board of Governors of the Federal Reserve System**

The task of the Federal Reserve, like that of all parts of our Government, is (in the words of the Employment Act of 1946) "to foster and promote free competitive enterprise" as well as "to promote maximum employment, production, and purchasing power." These four purposes may well be summarized under the single heading of orderly and vigorous economic growth.

*A statement before the joint meeting of the American Economic Association and the American Finance Association, Pittsburgh, Pennsylvania, December 28, 1962.

The Federal Reserve has recently been criticized for neglecting these goals in favor of another—the achievement of balance in our international payments. Other critics of the Federal Reserve, however, charge us with neglecting the international payments problem and with concentrating too much on domestic goals. Both criticisms overlook what seems to me an obvious fact, namely, that our domestic and international objectives are inextricably interrelated. We simply do not have a choice of pursuing one to the virtual exclusion of the other. Both must be achieved

together, or we risk achieving neither.

Thus, our domestic economic growth will be stimulated when our external payments problem is resolved. And our payments situation will be eased when the pace of our domestic growth has been accelerated. With more rapid growth, the United States will become more attractive to foreign and domestic investors, and this will improve our payments balance by reducing the large net outflow of investment funds.

In particular, accelerated growth will presumably lead to larger internal investment and credit demand, and so to some gradual rise in interest rates, not through the fiat of restrictive monetary policy, but through the influence of market forces. With rising credit demand pressing on the availability of credit and saving, the flow of funds from the United States to foreign money markets will be more limited. In addition, a closer alignment of interest rates internationally can be expected to result and this will help to reduce the risk of disturbing flows of volatile funds between major markets.

Similarly, the maintenance of reasonable stability in average prices, with progressive gains in productivity, is more than a basis for sustained domestic growth. It is also a necessary prerequisite for improving the international competitive position of our export industries and our industries competing with imports, and thus for increasing our trade surplus so that it can cover a larger part of our international commitments. This is not to deny that prices and costs of some of our individual industries may be out of line with those of foreign producers. There are doubtless industries where grievous competitive problems exist for international reasons, and in these cases a strong enterprise economy expects the necessary adjustments to be made through the efforts of such industries.

Even if our country did not suffer from an international payments deficit, our Government would still have to pursue the twin goals of orderly and vigorous economic growth and over-all price stability. The payments deficit provides merely another circumstance that the Federal Reserve must consider if it is to make an effective contribution to the fulfillment of the goals set by the Employment Act.

International role of the dollar

In reaching our decisions on domestic monetary policy then, the Federal Reserve cannot ignore our international financial problems. There might be countries or times in which there could be enough leeway to do so. But the United States is not such a country and the present is not such a time.

The United States at present is the financial leader of the free world, and the United States dollar is the main international currency of the free world. As long as this leadership exists, we are obliged to keep our policies compatible with the maintenance of the existing international payments system.

The increase in the volume of world trade and finance since World War II has led to an unprecedented integration of the world economy. This economy has become ever more closely bound together by ties of trade, investment, communication, transport, science and literature. Financially, the world economy has become coordinated by an international payments system in which the dollar serves both as a major monetary reserve asset and as the most important international means of payment. And the reliance that the world has come to place on the dollar requires that the dollar be always convertible into all major currencies, without restriction and at stable rates, based on a fixed gold parity.

It is in the light of the special international role of the United States and its currency,

and therefore of the responsibilities of the Federal Reserve, that a Federal Reserve concern with maintenance of our gold stock, our balance of payments and stability of the dollar exchange rate must be understood.

Above all, we must always have in mind that the role of the dollar in the international payments system is founded upon freedom from exchange restrictions. Whatever temporary advantage might be gained for our payments deficit by controls over capital movement or other international transactions would be more than offset by the damage such controls would do to the use of the dollar internationally.

Role of the U. S. gold stock

A persistent decline in our gold stock is harmful to the United States economy for two reasons: First, it endangers our international liquidity position, i.e., our continuing ability to convert on demand any amount of dollars held either by foreigners or by United States residents into any other currency they may need to settle international transactions. Second, because of our long-established domestic reserve requirements, a declining gold stock fosters uneasiness about a curtailed Federal Reserve flexibility to pursue domestic monetary policies otherwise regarded as appropriate and desirable.

Sometimes it is suggested that the decline in our gold stock could be avoided if we gave up our policy of selling gold freely to foreign monetary authorities for monetary or international settlement purposes. But a decline in our gold stock stems from the deficit in our international payments, not our gold policy.

A payments deficit initially means an accumulation of dollars in the hands of foreigners, as virtually all of their commercial or financial transactions with residents of the United States are settled in dollars. If foreign

corporations or individuals choose not to hold dollars, they convert them into their own or into other foreign currencies; in either case, the dollars fall eventually into the hands of one foreign central bank or another.

If in turn the foreign central bank acquiring dollars chose not to enlarge its dollar holdings and if it could not convert its dollar receipts into gold, it would present dollars to us for redemption into its own currency. Once United States holdings of that currency, including credit availabilities, were exhausted, we could acquire the currency only by selling gold. If the United States declined to sell gold in such circumstances, foreign private recipients of dollars could no longer count on converting dollars at par into their own or other foreign currencies.

Thus, a gold embargo would terminate the convertibility of the dollar at fixed values, not just into gold, but into any foreign currency. This would obviously be the end of the dollar as a currency that bankers, merchants or investors could freely use to settle their international obligations.

Since there is a statutory linkage between gold and our domestic money supply, through the minimum gold certificate reserve requirements of the Federal Reserve Act, consideration must also be given to the effect of changes in the United States gold stock on the gold certificate reserve ratio of the Federal Reserve Banks. At present, this ratio still exceeds the required minimum of 25 per cent both against Federal Reserve Bank deposits and against Federal Reserve notes. Should it fall below that minimum, the Board of Governors would have full authority to suspend the Reserve Bank gold certificate reserve requirements.

Some interest has been expressed in the mechanics of suspending these requirements. Let me summarize them at this point in brief-

est form. Upon action to suspend requirements, the Board of Governors would have to establish a tax on the Reserve Banks graduated upward with the size of their reserve deficiencies. The tax could be very small for as long as the reserve deficiencies were confined to the reserves against deposits and the first five percentage points of any deficiencies against Federal Reserve notes. If the reserve deficiencies should penetrate below 20 per cent of Federal Reserve notes outstanding, the tax would undergo a fairly steep graduation in accordance with statutory specifications.

The Federal Reserve Act further specifies that, should the reserve deficiencies fall below the 25 per cent requirement against notes, the amount of the tax must be added to Reserve Bank discount rates. But if the reserve deficiencies were confined to reserves against Reserve Bank deposits, the required penalty tax could be nominal and no addition to discount rates would be necessary.

It is perhaps easier to talk about this subject just now when the gold stock has shown no change for two months. But our progress this year in rectifying our international payments disequilibrium has fallen short of our target, in part because of a rise in our imports of 1½ billion dollars. Hence, we must now intensify our efforts to re-establish payments balance. And until we have regained equilibrium, we shall have to be prepared to settle some part of any deficits experienced through sales of gold.

Nevertheless, any decline in our gold stock large enough to bring its level significantly below the gold certificate reserve requirement of the Federal Reserve could raise further questions about maintenance of dollar convertibility. And it could also lead to heavy pressures on the United States monetary authorities to take strong deflationary action

that might be adverse to the domestic economy, or, alternatively, to pressures on Congress to devalue the dollar, a subject to which I return later. It is of utmost importance, therefore, to shorten as much as possible the period in which further large decline in our gold stock will occur and to hasten the arrival of a period in which our gold stock may from time to time increase.

The point I should like most to emphasize here is the following: No question exists or can arise as to whether we shall pay for the debts or liabilities we have incurred in the form of foreign dollar holdings, for that we most certainly must do—down through the last bar of gold, if that be necessary. What is in question is how we best manage our affairs so that we shall not incur debts or liabilities that we could not pay.

Balance of payments

To maintain the credit-worthiness of the United States, to support confidence in the dollar, to check the decline in our gold stock, to bring our international payments and receipts into balance without interfering with the convertibility of the dollar—these objectives are all synonymous one with another. We in the Federal Reserve are concerned about the balance of payments because it is

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vital that the full faith and credit of the United States not be questioned.

Our international payments deficit this year was less than $\frac{1}{2}$ of 1 per cent of our gross national product. That deficit did not represent a decline in our international wealth because the rise in our foreign assets exceeded the drop in our net monetary reserves. Yet the deficit was of vital concern in that it extended by one more a series of large deficits, a series that has now persisted for five years.

A payments deficit means either a decline in United States gold or foreign exchange reserves, or an increase in United States short-term liabilities to foreigners. In either case, it worsens the ratio of reserves to liabilities; in other words, it weakens the nation's international liquidity position.

The United States, as the free world's leading international banker, can fulfill its role only if it keeps the confidence of its depositors. No banker can suffer a continuous decline in his cash-deposit ratio without courting danger of a run.

The best method to combat a payments deficit is to improve the competitive position of our export industries and our industries competing with imports. This method can be effective only in the long run, but in the long run it is bound to be effective. And its accomplishment will have an expansive rather than contractive influence on our domestic economy as a whole.

Dollar exchange rate

Some economists have argued forcefully that as a general principle a country, suffering at the same time from external deficit and from domestic unemployment, should devalue its currency, either by a shift to a floating rate or by a change in its gold parity. But if there ever is any merit to that argument, say

in the case of countries whose currencies are not extensively used in international transactions, it is not applicable to the United States. This is so because the United States, as the world's leading banker, is responsible for a large part of the monetary reserves of foreign countries and for the great bulk of the international working balances of foreign bankers, traders and investors. We have accepted these balances in good faith and as I said earlier, we must stand behind them.

Whatever other consequences would follow from a devaluation of the dollar, I am convinced that it would immediately spell the end of the dollar as an international currency and the beginning of a retreat from the present world role of the United States that would produce far-reaching political as well as economic effects. It would, in my judgment, invite the disintegration of existing relationships among the free nations that are essential for the maintenance and extension of world prosperity and even world peace.

It has sometimes been suggested that we could maintain the dollar as an international currency simply by giving a gold value guarantee to some or all foreign holders of liquid dollar assets. At first glance, it might seem a good idea for a foreign central bank or a foreign investor to own an asset that would be not only as good as, but actually better than gold: a kind of interest-bearing gold. But I do not think that the suggestion for a gold value guarantee is realistic.

First, if foreign holders of dollars did not trust our repeated assurance that we would not devalue the dollar, they would hardly trust our assurance that, if we devalued the dollar contrary to our previous assurance, we would do it in such a way that some or all foreign holders would be treated better than domestic holders.

Second, I do not think it would be possible 13

to limit effectively a gold value guarantee to the dollars held by some or all foreign holders; and if it were possible to make an effective distinction between foreign and domestic holders, this would amount to unjustified discrimination against domestic holders. In my judgment, neither Congress nor public opinion would tolerate any such discrimination.

In spite of our international payments deficit, the United States has refrained from drastically cutting Government expenditures abroad for defense or for economic aid and from curtailing the freedom of capital movements. To have done otherwise would have undermined our position of economic and political leadership of the free world. So would any failure on our part to maintain the established par value of the dollar.

Role of the Federal Reserve

Within the limitations set by the international role of the dollar, what can the Federal Reserve do to achieve its domestic policy goals together with contributing to the achievement of international balance?

My friends sometimes accuse me of being a chronic optimist. But I believe that we can find ways of furthering our domestic economic aims while, at the same time, we are making progress in overcoming our payments problem internationally. And I believe that these ways will contribute better to sustainable economic growth than would flooding the economy with money.

Indeed, my present feeling is that the domestic liquidity of our banks and our economy in general is now so high that still further monetary stimulus would do little if any good—and might do actual harm—even if we did not have to consider our payments situation at all. This means that if any additional governmental action is needed in the financial field in order to give fresh expansive

impulse to the economy, it would probably have to come from the fiscal side. The part played by monetary policy, from both an internal and an external point of view, would then be mainly supplementary and defensive.

In this context, monetary policy would have to be on guard against two dangers: First, the danger that too rapid domestic monetary expansion would eventually produce rising domestic costs and prices as well as unwise speculation and in this way curtail exports and over-stimulate imports; Second, the danger that too easy domestic credit availability and too low borrowing costs would encourage capital outflows.

For the past few years, monetary policy has already contributed to the needed stability of the domestic price level, while prices in some other important industrial nations have been under steady upward pressure. In specific terms, Federal Reserve policy has been seeking to maintain a condition of credit availability that would be adequate for domestic needs while avoiding any serious deterioration of credit standards or any widespread speculative reliance on credit financing and at the same time limiting the spillover of credit funds—short-term and long-term—into foreign markets.

Nevertheless, our monetary policy has remained easier through this economic cycle than during previous cycles because that has seemed to be needed in a domestic situation of lagging longer-term growth and a less-than-robust cyclical expansion. In balancing the scope and the limitations of our monetary policy, however, I am convinced that, within limits imposed by human imperfection, the Federal Reserve has paid neither too much nor too little attention to our international payments problem.

As I mentioned at the outset, criticism of our policy through this economic cycle has

been about equally divided between two groups. The first complains that we have violated the classical principle of an international payments standard based on fixed exchange rates by failing to contract our money supply in the wake of a decline in our gold reserves. The second complains that we have neglected our duties to the domestic economy by permitting the decline in our monetary reserves to have some impact on our money markets, especially on short-term interest rates.

If all criticism had come from one side only, I would still believe it unjustified. But the very fact that criticism comes from both sides inclines me even more strongly to the comforting thought that we have been keeping to the golden mean.

Foreign currency operations

The Federal Reserve has not been content to limit its participation in solving the country's payments problem to its traditional tools of monetary policy. It has felt a particular need to set up defenses against speculative attacks on the dollar pending an orderly correction of our payments disequilibrium. And it has felt a more general need to cooperate directly with foreign central banks in efforts to reinforce the international payments structure. Recognition of these needs underlies the decision that we took just a year ago to participate on Federal Reserve account in foreign currency operations.

Since the Treasury also engages in similar operations, Federal Reserve activities have had to be, and will continue to be, conducted in cooperation with those of the Treasury. Smooth coordination has been facilitated by the fact that the instructions of both agencies are carried out through the same staff members of the Federal Reserve Bank of New York, headed by Mr. Charles A. Coombs,

Vice President in charge of the Foreign Department of that Bank and Special Manager for Foreign Currency Operations of the Federal Open Market Committee. At the same time, both the Board of Governors and the Federal Reserve Bank of New York have endeavored to maintain close contact with the central banks of foreign countries, bilaterally as well as through regular meetings of the Organization for Economic Cooperation and Development in Paris and the Bank for International Settlements in Basle.

The most important foreign currency activity of the System thus far has been the conclusion of reciprocal currency arrangements with leading foreign central banks and the Bank for International Settlements. Under these arrangements, the System acquires, or reaches agreement that it can acquire on call, specified amounts of foreign currencies against a resale contract, usually for three months. Concurrently, the foreign central bank acquires, or can acquire on call, an equivalent amount of dollars under resale contract for the same period.

In these contracts, both parties are protected during the active period of a swap arrangement against loss in terms of its own currency from any devaluation or revaluation of the other party's currency. These arrangements, of course, are subject to extension or renewal by agreement. Interest rates paid on the deposit or investment of funds acquired through swaps are set at equal levels for both parties, in the neighborhood of the current rate for U.S. Treasury bills, so that, as long as neither party utilizes any of its currency holdings, there is no gain or loss of income for either.

So far, agreements have involved a total approximating 1 billion dollars. For the most part, they are stand-by arrangements. Only a small fraction of actual currency drawings

has been utilized for market operations. And a large part of amounts so utilized has been reacquired and used for repayment of the swap drawings.

In entering into swap arrangements, the Federal Reserve has had three needs in view. First, in the short run, swap arrangements can provide the System with foreign exchange that can be sold in the market to counter speculative attacks on the dollar or to cushion market disturbances that threaten to become disorderly.

Second, swap arrangements can provide the Federal Reserve with resources for avoiding undesired changes in our gold stock that may result when foreign central banks accumulate dollars in excess of the amounts they wish to hold, especially if these accumulations seem likely to reverse themselves in a foreseeable period.

Third, when the United States balance of payments has returned to equilibrium, swap arrangements with other central banks may be mutually advantageous as a supplement to outright foreign currency holdings in furthering a longer-run increase in world liquidity, should this be needed to accommodate future expansion of the volume of world trade and finance.

Concluding remarks

As long as the United States balance of payments is in over-all deficit, and we are therefore losing rather than gaining monetary reserves, on balance, the Federal Reserve cannot expect to accumulate outright large amounts of foreign exchange. Meanwhile, System holdings of foreign currencies will necessarily be limited to relatively small amounts, swollen on occasion by swaps.

But over the longer run, the System may find it useful to increase gradually its foreign currency holdings and operations. This de-

velopment could be modified, of course, by further changes in the institutional framework of our international payments system. For this reason, the Board's staff, in cooperation with the staffs of the Treasury and other interested agencies of the Government, is carefully scrutinizing the various recent proposals designed to adapt, strengthen or reform this framework.

Whatever the fate of these reform proposals, it seems likely that Federal Reserve operations in the international field will need to be continued for the foreseeable future. The Federal Reserve's involvement in foreign exchange problems is the inevitable consequence of its role as the central bank responsible for the stability of the world's leading currency. Such a responsibility necessarily carries with it the responsibility for helping to preserve and improve the existing international monetary system, thus to contribute to the stability and prosperity of the free world.

1962 Annual Report

The 1962 Annual Report of the Federal Reserve Bank of Chicago features a study of the construction industry as well as the Bank's financial statements and brief reviews of last year's developments in Seventh District business, agriculture and banking. The construction analysis traces activity in homebuilding, nonresidential private construction and public works during the 1946-62 period. Changes in the stock of structures, financial and technical developments and the stability of the industry relative to general business are emphasized. Copies of the Annual Report may be obtained by writing to the Bank.