

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

Business Conditions

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THE Trend OF BUSINESS

The business uptrend gained momentum in the summer and early fall, both in the nation and the Midwest. Production, employment and income rose at a quickened pace and order backlogs of durable goods producers continued to mount.

Major labor-management negotiations were being resolved without widespread work stoppages, although with more generous package settlements than had been generally anticipated. Increases of 4 to 5 per cent in total hourly compensation in some industries exceed average annual productivity gains of slightly over 3 per cent for the economy and, therefore, have long-run inflationary implications. In the near-term future, the avoidance of strikes would help to maintain expanding production and favorable supply conditions.

The index of wholesale prices, after six and one-half years of relative stability, apparently has been nudged slightly upward, mainly by increases for metals and livestock. Some factors behind these price increases are transitory—for example, strikes and political unrest abroad for copper, and the “farmers’ strike” for beef cattle and hogs. But any up-

ward movement in the general price level bears close watching. Price indexes provide the thermometers that reflect the “overheating” of the economy that occurs when demand for goods and services presses too closely upon total productive capacity.

Is capacity cramped?

Since 1957, margins of unused manpower and productive facilities have served as barriers to the resumption of a general rise in commodity prices. In recent months there have been signs that these margins have narrowed. While the total supply of workers remains ample, there are widespread reports of shortages of workers having the needed experience and skills. A similar situation prevails in the case of plant and equipment. Total capacity is not being taxed, but facilities that produce some goods are being utilized fully.

Satisfactory measurements of capacity—whether for individual plants, whole industries or the entire economy—are elusive. Ceiling output in particular plants may be determined at any given time by the number of work shifts, the quality of labor force, man-

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agement and equipment, the standards of inspection applied to finished products, the product mix, the availability of supplies and many other factors. Nevertheless, there are a number of clues that give indications of increases in demand relative to the ability of producers to increase output. Among these are changes in backlogs and delivery schedules, as well as prices.

Unfilled orders for all types of durable goods, which have been rising since last December, reached 51.6 billion dollars at the end of August—an increase of 10 per cent from the year-earlier period. Even larger increases in order backlogs have been reported for metals and most capital goods including machine tools, freight cars and construction machinery.

Typical delivery schedules for some types of steel that are in strong demand such as sheets and plates have stretched out substantially in recent months, and producers of some capital goods have been forced to lengthen promised delivery times. In August, 22 per cent of the purchasing agents of Chicago, representing many different businesses, as compared with 10 per cent a year earlier, reported that they were ordering supplies 60 days or more in advance of delivery.

But rising backlogs and lengthened delivery times must be viewed in perspective. Despite the rise in unfilled orders of durable goods producers, backlogs at the end of July were only 2.7 times monthly shipments, compared with 2.6 times a year earlier. Moreover, this ratio remained near the postwar low.

Although most capital goods producers have had large increases in orders this year, many Midwest producers of equipment used in agriculture, construction and industry indicate that they could accommodate an even larger volume of business without strain on available capacity.

Building materials such as cement, lumber and wallboard remain in ample supply. Delivery schedules for most nondurable goods including chemicals, paper products and petroleum products have been well maintained despite strong demand. Prices of some basic chemicals have strengthened in recent months after being under downward pressure for several years, but there has been little general tendency for prices of soft goods to rise.

Steel demand continues to mount as production of goods containing steel rises further and as moves to increase inventories are implemented. In late September steel ingot production reached an annual rate of 130 million tons, far more than the 117 million tons the industry turned out in record 1955. The production rate is expected to move higher but not approach closely the 165 million ton rate that the industry is believed capable of reaching under full draft.

The supply of basic steel is not likely to constitute a bottleneck as it did as recently as in 1955 and some earlier years; however, capacity to produce plates and sheets of the quality and dimensions desired by users already is being strained. If major steel users should undertake to build inventories above normal requirements, as has been reported in the press, the supply situation could tighten further. At present, the signs associated with periods of peak steel demand in the past—lowering of quality standards, sharp increases in imports and “gray markets” in which steel is resold at premium prices—have not been apparent.

There have been reports of shortages of freight cars, particularly gondolas used to move steel products. Various substitutes have been employed, including flat cars and highway haulers. In addition, railroads have been renovating substantial numbers of freight cars that had been scheduled for scrapping

and have boosted orders for new equipment.

In recent weeks various firms, particularly producers of steel and aluminum, have reopened facilities that had been idle for years and were slated for dismantling. These occurrences dramatize the vigor of the current expansion, especially in the hard goods.

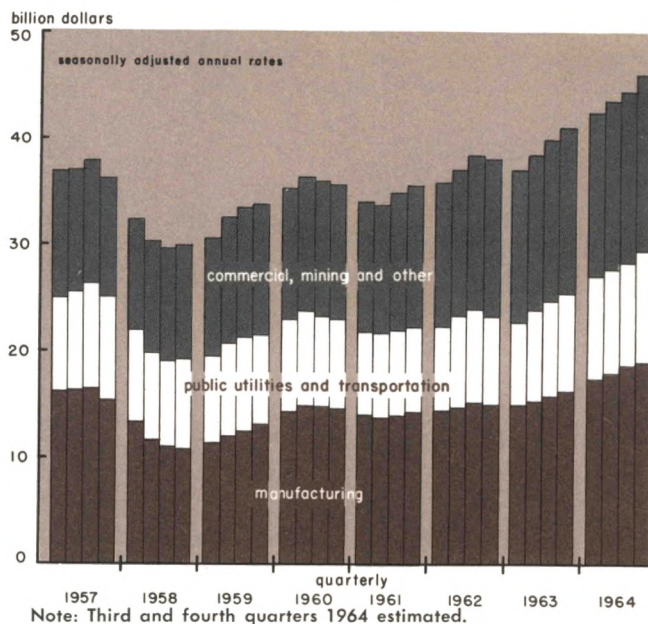
Activation of unused, obsolete plants necessarily incurs substantial start-up costs resulting from the need to renovate equipment and train additional personnel. Also, operating expenses are higher than for modern facilities. On the bright side, the ability of manufacturers to bring idle plants into production testifies to the flexibility of American industry when demand rises and constitutes a safety valve against inflationary pressures.

In short, pressure upon capacity appears to be concentrated in particular areas of demand and has not become nearly so general as in the mid-Fifties when inflationary pressures gained dominance. Stringencies are being resolved in some instances by steps to increase output through more extensive use of existing equipment. In addition, new facilities will be completed in the months ahead in larger volume than in recent years.

Capital expenditures rising further

In 1964 United States businesses expect to spend 44.2 billion dollars on new plant and equipment, 13 per cent more than last year's record total. The current estimate, released by the Department of Commerce in September, represents a moderate upward revision from last March when a 10 per cent increase

Business plant and equipment expenditures continue strong uptrend



in capital outlays was foreseen.

At the indicated level, this year's capital expenditures are likely to slightly exceed 7 per cent of total spending on goods and services—up from 6.7 per cent in the 1961-63 period but well below the 8.4 per cent ratio reached in 1956-57. The current level of capital spending, therefore, is not of boom proportions relative to total output nor is it expected to reach that stage in the months immediately ahead.

Early evidence shows capital spending plans for 1965 to be well advanced. Many orders for large capital goods placed recently contemplate deliveries six to nine months hence. Construction contracts for manufacturing buildings reported by F. W. Dodge in the January-July period were 16 per cent above last year in the nation and 29 per cent higher in the Midwest. In addition, *Iron Age*

reports that new capital spending projects approved by metalworking producers—including primary metals, fabricated metal products, machinery and transportation equipment—in the second quarter were far ahead of any previous quarter in the six-year history of its survey. Approvals of new plans by the steel industry were especially large.

Capital expenditure programs now under way and in prospect, of course, are concentrated in facilities to produce those goods for which demand is strongest. Cramped supply situations that appear to be developing at present, therefore, will be alleviated in time. In the past, notably during the Korean War and in the mid-Fifties, surges in capital spending were so abrupt as to tighten bottle-

necks for some time and were followed by sharp reductions in total outlays once the peak had been passed. Such cutbacks in capital expenditures typically have been associated with general business recessions. It remains to be seen whether the present movement will continue to be kept within the limits that can be accommodated by producers of capital goods without sharp increases in backlogs and prices that would have widespread effects throughout the economy. If a capital expenditure boom is developing, it may be dampened or offset by a leveling or decline in demand for some consumer durables, housing and military hardware. These segments of demand combined substantially exceed total spending on business plant and equipment.

International developments and monetary policy

J. Herbert Furth, Adviser

*Board of Governors of the Federal Reserve System**

Monetary policy and international developments are mutually interrelated.

Monetary policy affects international transactions in four ways. Through the impact on domestic price and wage movements, it influences the competitive position of domestic industry and thereby the exports and imports of goods and services. Through the impact on cost and availability of domestic credit, it in-

fluences interest rate differentials and thereby international flows of interest sensitive long- and short-term capital. Through the impact on profits and profit expectations, it influences international flows of equity capital, including direct and portfolio investments. And through the combined impact on all these items in the balance of payments, monetary policy influences expectations regarding exchange rate fluctuations and thereby international flows of short-term funds for purposes of speculation or hedging.

Developments abroad, in turn, affect monetary policy through their impact on inter-

*A paper presented at a Seminar on Central Banking for college teachers of money and banking at the Federal Reserve Bank of Chicago, September 10, 1964. The paper reflects the author's personal views and should not be interpreted as representing the opinion of the Board of Governors.

national commercial and financial transactions. These transactions influence domestic price and income levels, interest rates, profit expectations and spot and forward exchange rates; and the resulting changes in international flows of funds affect the liquidity of the banking system and of the economy as a whole. Hence, developments abroad influence, at least marginally, all the variables which the monetary authorities have to take into account in deciding upon their policy actions.

International considerations are particularly important for monetary policy whenever the monetary authorities feel under obligation to influence a country's balance of international payments. Modest deficits or surpluses may be disregarded, especially if they alternate in reasonable periods so that they do not produce a large and persistent inflow or outflow of monetary reserves. But if deficits or surpluses show signs of becoming large and persistent, the monetary authorities may feel compelled to review their policies so as to correct, or at the very least not to perpetuate or aggravate, that imbalance.

Measuring the deficit

Sometimes it is difficult to decide whether or not a country's international payments are in balance. In the year ending June 30, 1964, for instance, the United States payments deficit amounted to 1.8 billion dollars according to the conventional calculation. This assumes that debt prepayments received by the U. S. Government are not to be considered regular receipts—although the lending operations that generate such debt are considered regular expenditures. If this peculiar assumption is abandoned, the deficit is reduced to 1.0 billion dollars. The conventional calculation also assumes that investments of foreign private short-term funds in the United States in

the form of bank deposits or money market paper are not considered receipts either—although again similar investments of United States funds abroad are considered expenditures. If this asymmetry is likewise removed, the deficit is further reduced to 0.7 billion dollars. Finally, one might take the position—which I would not recommend but which would conform to the practice of many foreign countries—that an increase in medium-term debts of the Government such as the issue of intermediate-term Treasury bonds (commonly referred to as “Roosa bonds”) to foreign monetary authorities and drawings on the International Monetary Fund should be considered as actions reducing rather than financing the payments deficit. Under this assumption, the United States deficit for the year ending June 30, 1964, would be reduced to the negligible amount of 0.2 billion dollars.

This problem of alternative methods of computing the payments balance arises only under our present international payments system. Under the textbook version of the gold standard, the balance was fully reflected in changes in gold reserves and, through the resulting adjustment in the country's supply of money and credit, eventually in movements of the domestic price and income level.

Similarly, if we were to adopt the proposals of some economists and permit all exchange rates to fluctuate freely without central bank intervention, changes in a country's payments balance would be automatically reflected in fluctuations in its currency's exchange rate, and through the impact of these fluctuations on import and export prices eventually reflected again in movements of the domestic price and cost level.

This comparison illustrates the basic difference between the present international payments system—which I like to call the reserve currency system for reasons which

will soon become apparent—and the other systems that have either been tried in the history of modern capitalism or have been proposed by reform minded economists and politicians. Only under the present system do monetary authorities enjoy—or suffer from—a large though not unlimited degree of freedom from restraints imposed by changes in a country's payments balance.

In contrast to a system of freely fluctuating exchange rates, the present system gives the monetary authorities not only the right but the duty of using their reserves or credit facilities to avert rate fluctuations outside the narrow limit permitted under the Articles of Agreement of the International Monetary Fund—unless they shift to a new par value for their currency.

In contrast to the gold standard, the present system permits the monetary authorities to offset the domestic effects of reserve changes so as to keep the supply of money and credit adjusted to domestic requirements. Hence, changes in the payments balance are not necessarily, and certainly not automatically, reflected in changes in domestic prices and incomes.

Obviously, the economic transactions making for a payments imbalance (for example, an export surplus) have some direct effect on the domestic economy, regardless of the ability of the monetary authorities to avoid an impact on the resulting reserve changes on the supply of domestic money and credit. But given the appropriate use of the tools of monetary policy, the authorities will be able to deal with those effects in the same way as with purely domestic disturbances.

Credit facilities for purposes of financing a payments deficit were, needless to say, available to monetary authorities also under the gold standard. But the volume of such credits was strictly limited by considerations of their

effect on gold movements. United States monetary history records several instances in which the authorities found it difficult to borrow gold in case of need either from foreign or from private domestic holders.

Under the present system, international transactions are settled not only among private bankers, businessmen or investors but also among governments and central banks primarily, if not exclusively, by means of a few internationally acceptable currencies, among which the dollar plays the most important role. Virtually, all central banks use the dollar as the exclusive vehicle for their foreign-exchange operations and therefore must hold larger or smaller proportions of their reserves in the form of dollars. Hence, the present system is in effect based on a reserve currency standard.

Reserve currencies "elastic"

Reserve currencies, in contrast to gold, can be created by decision of the reserve center's monetary authority. Any United States importer or investor can settle his foreign obligations by paying dollars and can get these dollars (through the intermediary of his bank) from the Federal Reserve—as long as the Federal Reserve is willing to make them available. Any foreigner can do the same: he can get the dollars either from his own central bank—not only to the extent that that bank holds dollar reserves, but beyond this point as long as the Federal Reserve is willing to make dollars available to that central bank—or like a United States resident through a domestic bank, again as long as that bank can get them in turn from the Federal Reserve.

In this way, international liquidity can be made as elastic as the monetary authorities of the reserve centers decide. Insofar as peripheral, nonreserve countries can count on as-

sistance from those authorities, the freedom of domestic monetary policies from balance of payments constraints is enjoyed by the peripheral countries as well as by the reserve centers.

This freedom is further enhanced by the emergence of an international lender of last resort, the International Monetary Fund. At any given time the resources of the fund are limited to a specified amount. But this amount can be increased by vote of its members: in 1959 the limit was raised by one-half and is widely expected to be raised further next year. Here again, the limits depend on the decision of the monetary authorities rather than on the physical availability of gold.

Clearly, however, the possibilities of increasing the supply of reserve currencies are not unlimited. If the supply of dollars to foreigners became excessive, the universal acceptability would be threatened. The acceptability of the dollar of an international means of payments is more vulnerable than that of domestic money. Domestically, money has legal tender status. But in international transactions, the use of any given means of payment is completely voluntary, and any development that undermines confidence in its stable value can put an end to its international circulation.

For these reasons, any system based on the use of a fiduciary asset such as a reserve currency as means of international payments must necessarily and continuously be walking a tightrope, trying to avoid the abyss of liquidity shortage on the one hand and that of excess liquidity on the other.

Risks and opportunities

Fortunately, the reserve currency system has a built-in mechanism that keeps the system approximately in balance. If the United States suffers from a large and persistent pay-

ments deficit and as a result puts too many dollars into international circulation, the dollars tend to flow from foreign businessmen, investors and commercial banks to their central banks. These central banks in turn will present their excess dollars to the United States for redemption in gold or, under the IMF articles, into their own currency. Thereby, they can force the United States to deplete its gold reserves, or to draw the currencies of surplus countries from the fund or to use its credit, say, in the form of Roosa bonds. All these steps put pressure on the United States to correct its payments imbalance and thereby to eliminate the source of dollar redundancy abroad.

Conversely, if the international availability of dollars is insufficient, foreign countries will increase their pressure for assistance both directly from the United States and from international agencies. During the past 20 years, such pressures induced the United States to help finance such agencies as the International Monetary Fund and to institute bilateral currency swaps. Moreover, the freedom from the constraints of the gold standard permitted the United States to extend aid through such schemes as the European Recovery Program, President Truman's "Point Four" program, the World Bank and its affiliates, the Inter-American Development Bank and the Alliance for Progress.

To sum up, the freedom of domestic policies from payments constraints presents risks as well as opportunities. This freedom has enabled the Federal Reserve to offset completely the domestic effects of the outflow of gold resulting from the United States payments deficit, and thus to generate the funds that were needed to finance our economic expansion. Such policy, however, tends to impede the equilibrating mechanism that was generated under the so-called classical gold

standard. Since an outflow of gold no longer necessarily results in a tightening of monetary policy, with a resulting downward pressure on prices and incomes and upward pressure on interest rates, it no longer necessarily reduces imports or attracts foreign capital.

In other words, while the new system has freed the world from the periodically recurring danger of virtually automatic monetary contraction, with its depressive effect on economic activity, it has made possible larger and more persistent payments imbalances.

Achieving balance

This situation does not pose any great difficulty if a country's international surplus coincides with domestic underemployment or its international deficit with domestic overemployment. Expansionary monetary and fiscal policies can remedy both ills in the first case; restrictive policies can do the same in the second.

A peripheral country is not faced with a serious problem even in the two cases of what is called in the fund articles "fundamental disequilibrium"—that is, the coincidence of domestic underemployment with a payments deficit and of domestic overemployment with a payments surplus. Currency depreciation or appreciation again can correct both the underlying domestic and the international cost-price imbalance.

But if a country has an internationally important capital market, a change in its currency's par value may well result in disruptive international capital movements, as in the German and the Netherlands revaluations in March 1961. If the country is a reserve center, a change in the par value of its currency would destroy that currency's function as an international means of payments and as a reserve asset. We know what happened to the pound sterling, and in consequence to the net-

work of international trade and finance, when sterling was devalued in September 1931.

Even in the case of a reserve center in fundamental disequilibrium, the question of eliminating a payments surplus presents no insoluble policy problem. Any country can presumably correct a payments surplus by unilateral reduction in tariffs and other import barriers. Such action would have the same effects on imports as a revaluation of the currency; but these effects would not extend to capital movements. Hence only the problem of a large and persistent payments deficit of a reserve center suffering from large and persistent domestic underemployment is really bothersome.

How do these considerations apply to the present United States situation and to our present problems of monetary policy?

The United States has suffered from the *one* case of international imbalance for which there is no fully satisfactory traditional remedy. It has experienced, for the past seven years, both considerable domestic underemployment and a large payments deficit. Let us see how this situation affects monetary policy in regard to its main points of impact: 1) price-cost relations; 2) differences in credit cost and availability; 3) profits and profit expectations, and 4) exchange-rate expectations.

In three out of these four points, there is no conflict between the domestic and international purposes of monetary policy. Domestically as well as internationally, we must preserve reasonable stability of costs and prices—domestically, as the basis of sustainable and orderly growth; internationally, as the basis of our trade surplus.

Domestically and internationally, we must strive for an economic climate of continuous growth and expansion permitting a reasonable level of present and expected future

profits—domestically, in order to stimulate investment; internationally, in order to stem the outflow (and perhaps induce an inflow) of equity capital.

Domestically and internationally, we must maintain a stable exchange value of the dollar—domestically, on grounds of equity and in order to encourage saving, but especially in order to permit rational long-range planning and accounting; internationally, in order to avert disruptive speculative capital movements.

Interest rates

There is only one point in which there might be at times a divergence of domestic and international considerations: the cost and availability of domestic credit—in short, the level of United States interest rates. Domestically, we need a level as low as compatible with the avoidance of an inflationary boom, in order to encourage enterprise and investment. Internationally, we need a level high enough to discourage outflows of interest sensitive arbitrage funds.

Some observers believe that this goal can be reached by keeping short-term rates high and long-term rates low. They believe—rightly—that domestic investment demand depends more on the rates for long-term than on those for short-term capital; and they believe—more questionably—that international capital flows depend more on short-term than long-term rates. Hence, they advocate what has been called “operation twist”—concentration of restrictive measures on short-term rates, such as the discount rate, the Treasury bill rate and bank deposit rates, and avoidance of restrictive measures affecting long-term rates. This operation means that a relatively larger part of the public debt is financed through short-term issues, and that Federal

times the sale of bills and the purchase of bonds.

But twist operations have obvious limits. Successful debt management requires a balance between short- and long-term debt that proves acceptable to the market and cannot therefore be based exclusively on twist consideration; and in fact, recent debt management operations have on balance lengthened rather than shortened the maturity of the public debt.

Moreover, at least in the longer run, arbitrage between various maturities necessarily tends to restore a market equilibrium between short- and long-term rates that may be impervious to moderate twist operations of debt management and monetary policy. Although recent actions of the monetary authorities have been concentrated on the short-term sector, several long-term rates have advanced in sympathy with short-term rates, although, as usual, much less so.

And finally, the international effectiveness of moderate unilateral changes in short-term rates on the United States payments balance is questionable. Immediately after the rise in the Fed discount rate in July 1963, bank reported outflows of short-term funds dropped from 400 million dollars in the second quarter to 100 million dollars in the third. But in each of the following three quarters they rose again to amounts larger than the record volume preceding the rate increase.

Three reasons may be advanced for this disappointing result.

First, not all flows of short-term funds are interest sensitive; quite a few of them depend on such factors as, say, the volume of foreign trade.

Second, insofar as these funds are interest sensitive, they are primarily determined by rate differentials rather than rate levels. If the major foreign money market centers follow a

rise in United States rates—as they frequently if not invariably tend to do—the United States move cannot change the differential.

Third, in many if not most cases, movements of short-term funds are covered against exchange risks by forward exchange transactions. In these instances, the determining differential is based on gross interest rate's differences *plus* or *minus* a forward premium or discount on the currency into which funds are moved in relation to the currency out of which they are moved and into which they are expected to be repatriated. If a rise in the discount rate is interpreted as a sign of weakness in the country's international payments position, the forward rates for the currency in question will deteriorate, and this deterioration may fully, or even more than fully, offset the advantage gained by the rise in the gross interest rate differential.

As mentioned earlier, it seems doubtful whether all movements of short-term funds should be considered as affecting the payments balance. If Canadian banks offer higher deposit rates than American banks, and a United States corporation deposits its funds with the New York agency of a Canadian bank—has the net liquidity position of the United States been damaged by that act? After all, the increase in liquid dollar holdings of the Canadian bank has been exactly offset by the increase in liquid claims of United States residents on the Canadian bank. If this position is sound, most—though by no means all—flows of short-term funds become neutral from the point of view of payments analysis, and there is no sense in letting monetary policy deviate from its domestic interest rate standards for the sake of achieving an economically meaningless “statistical” improvement in the payments balance.

This reasoning does not apply to long-term

flows—which, incidentally, in the case of the United States are often larger than short-term flows. The granting of a long-term credit, in the form of bank loans or bond issues, by a United States investor to a foreign borrower means indeed a deterioration in the short-run United States international liquidity position—though not necessarily in the long-run position and obviously not in the United States international net asset position. But long-term flows cannot be affected by measures designed merely to raise short-term interest rates. They can be affected only by measures tightening credit availability (or domestic liquidity in general) and raising long-term rate levels. In fact, since for obvious reasons long-term rates in the relatively capital poor foreign countries are and must remain, with few exceptions much higher (even after adjustment for risk factors) than in the relatively capital rich United States, only a serious tightening and a resulting large increase in long-term rates could hope to influence long-term flows of American capital.

Fiscal versus monetary policy

For this reason, changes in long-term differentials may be proper goals of fiscal rather than monetary policy. The recently enacted Interest Equalization Tax (IET) means for some specified types of financing the creation of an artificial 1 per cent differential between long-term rates in the United States and in developed countries outside the Western Hemisphere. It therefore takes the place of a monetary policy that would have had to be so restrictive as to raise long-term rates by 1 per cent. Under existing conditions of underemployment, such a restrictive policy would presumably have done great harm to domestic real investment and hence to output, employment and economic growth.

It is too early to tell whether this pioneer-

ing experiment in the use of fiscal rather than monetary measures for the purpose of affecting interest rate differentials will turn out to be successful. If it does, it may open the way to a completely new consideration of payments adjustments. Until recently, virtually all adjustments were made or attempted primarily if not exclusively by means of influencing price-cost differentials in merchandise trade; fiscal measures of the type of the IET could lead to adjustments primarily or exclusively through creation or elimination of price-cost differentials in credit and capital flows. Such adjustments should have fewer adverse repercussions on money incomes and thus on real economic activity in both the deficit and the surplus countries since they would be free of deflationary or inflationary implications.

But this would not mean that monetary policy would be relegated to a minor role. Simultaneously with the first exploration of these new means of fiscal policy, the Federal Reserve has experimented with new tools of international monetary policy, that is, mutual holdings of major currencies. At present, only the first steps in this direction have been taken. The Fed has concluded "swap" arrangements with 12 foreign central banks, involving a potential total of 2 billion dollars. These arrangements permit the participants to draw funds for periods of three months, renewable for a maximum total period of one year, under full exchange value guarantee. They are designed to avoid disorderly exchange markets or disruptive temporary and reversible flows of short-term funds. They are not designed to correct or even finance a more basic payments disequilibrium.

If, however, mutual currency holdings become a matter of routine, it would be possible to free such holdings from the restrictions

of the present swap arrangements and to finance longer payments swings by changes in the mutual balances. Such use of mutual currency holdings would be an even more important supplement to present sources of international liquidity, without interfering with the basic functions of the existing payments system.

But these technical experiments should not blind us to the more basic problems of international monetary policy. The theory and practice of monetary policy in general, and of international monetary policy in particular, have all too long resembled the state of medicine painted by Molière, when doctors allegedly discussed only whether every illness should be treated by bleeding or by purging. Our European brethren and some of their domestic followers tell us that all ills could be cured by monetary restriction; and some of our domestic critics, economists as well as politicians, tell us that they could be cured by monetary expansion, perhaps facilitated by a preordained rate of rise in the money supply, by flexible exchange rates or by an international supercentral bank.

The two examples of new financial instruments just mentioned may suggest that there is more to international monetary policy than simple expansion or contraction. But before we can hope to discover further instruments, or even to use the existing ones to full capacity, we must learn far more about the actual working of the international monetary system. All too many economists have spent the last few years in explaining why the system does not work perfectly: few if any have bothered to try to explain why and how it works at all. As teachers of international monetary theory and policy, you will be able to lead your students into virgin land that is waiting for fresh minds to explore its wonders.

Downturn in homebuilding?

Residential construction, as measured by private nonfarm housing starts, has moved erratically downward since late 1963. In August of this year, starts were at an annual rate of slightly less than 1.4 million units. This was well under the rate of more than 1.6 million in the closing months of 1963 and the first quarter of this year and somewhat below the level in the second quarter.

Until recently in the current business expansion, which began in early 1961, homebuilding had been growing at a faster rate than overall activity. Compared with year-earlier levels, private nonfarm housing starts

were up 4 per cent in 1961, 12 per cent in 1962 and 8 per cent in 1963; by contrast, year-to-year gains in gross national product (in constant dollars) during the same periods were only about half as great.

There have been three major postwar cycles in residential construction. The first of these topped out in 1950, the second in 1955 and the third in 1959. Concern has been expressed recently that the latest expansion in homebuilding may be similarly topping out this year, if indeed it has not already done so.

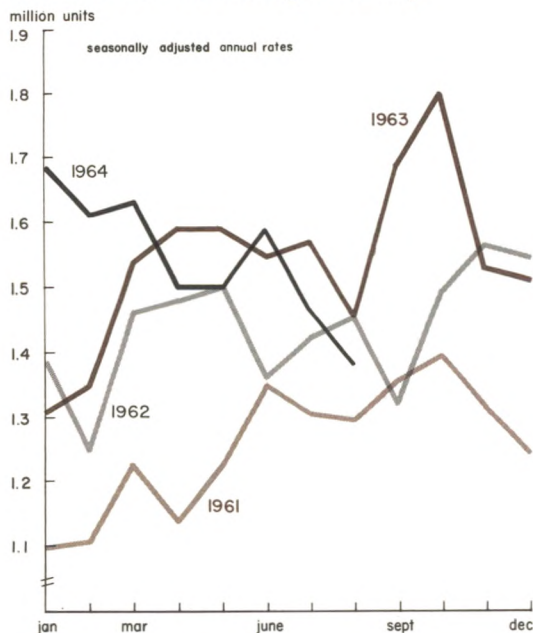
Contributing to the impression that housing construction may be past its fourth postwar peak is a decline in permit activity. Since the issuance of permits usually precedes initiation of construction, movements in permit volume give an indication of the forthcoming trend in starts. In the second quarter of 1964, the annual permit rate (seasonally adjusted) averaged 7 per cent below the first quarter. A further small decline occurred in the average July-August rate.

Indications of a downturn in residential construction have appeared against a background of stable vacancy rates and rising rents and construction costs, the latter attributable largely to rising wages in the building trade.

Contract awards at high level

Although the number of starts has been drifting downward, the volume of construction contract awards during the first seven months of 1964 suggests that the pace of homebuildings should continue at a high, if declining, level through at least the remainder of the year. Residential contracts, reported by

Private nonfarm housing starts have been declining recently



the F. W. Dodge Corporation, totaled 11.9 billion dollars from January to July this year—up 6 per cent from the comparable months of 1963. The margin over a year ago, however, has been narrowing somewhat since the early months of 1964.

Similarly, commitments by savings and loan associations and life insurance companies to finance future housing construction increased over this period. During the first half of 1964, outstanding mortgage commitments of savings and loan associations were an estimated 8 per cent above last year's level while those of life insurance companies were up almost as much.

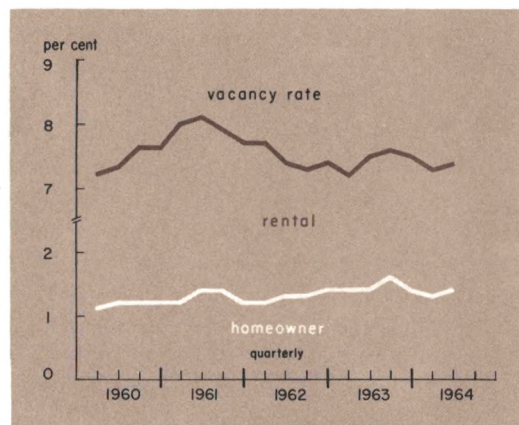
Multi-unit housing pace slackens

In recent years the fastest growing segment of the housing market has been the multi-unit structure. Nationally, such units accounted for 38 per cent of private nonfarm starts in 1963 as compared with 26 per cent in 1960.

Amid continued reports of "overbuilding," the number of apartment permits authorized on a seasonally adjusted basis has been trending downward since the beginning of 1964. Nevertheless, several factors indicate that apartments and other multi-family units will continue to constitute an important segment of housing construction and may be relatively stronger than the single-unit category. Among the more important of these are the changing age composition of a continually growing population and the increasing distances and costs of local transportation in large metropolitan areas.

The course of multi-unit construction is related to the increasing proportions of the young and the old in the total population. Young married couples tend to live in apartments while accumulating savings for down-

Vacancy rates remain stable



turn to apartments from single-family homes in order to enjoy the economy and easier maintenance of smaller quarters. In the past two or three years, townhouses and condominium apartments and comprehensively planned residential communities, especially tailored to appeal to older couples, have accounted for a growing share of the multi-unit housing market.

Midwest building well up from 1963

During the first seven months of 1964, percentage gains from the corresponding year-earlier period in the number of permits to build residential units in several important District areas have been much larger than for the nation.

Demand for housing in the *Detroit* area has been stimulated by increased employment and income associated with the high level of auto production. Permits were up 27 per cent over 1963 in the initial seven months of 1964, following a 14 per cent increase in 1963 and a 23 per cent gain the previous year. Historically, residential construction in Detroit has been concentrated in single-family dwell-

ings and during the first half of 1964 permits for such structures accounted for 67 per cent of the total issued. The multi-family component has been growing, however, as single-family permits had represented 72 per cent of the total in 1963 and 90 per cent in 1961.

The *Chicago* metropolitan area, with a population approaching 7 million, is the largest housing market in the Midwest. Permits for the first seven months of 1964 were up 1 per cent from a year earlier. This upturn followed year-to-year declines of 7 per cent in 1963 and 8 per cent in 1962. Apartment activity continues to be important in the *Chicago* area with permits amounting to 51 per cent of the total as compared with 44 per cent for the nation.

Milwaukee has experienced a large increase in homebuilding activity this year. For

the first seven months, permit volume was up 15 per cent from the comparable 1963 period. This follows a year-to-year increase of 17 per cent in 1963 and decline of 16 per cent in 1962. *Milwaukee's* proportion of permits issued for multi-family units is slightly above the nation's.

Of the major District cities, only *Indianapolis* has had a decrease in permits in 1964. During the first seven months of the year, permits were 5 per cent below 1963. This compares with a 1962-63 rise of 3 per cent and a year-earlier gain of 7 per cent. About half of the *Indianapolis* permits issued this year, as well as last, have been for multi-family construction. This is sharply above the multi-family proportions of 28 per cent in 1962 and 14 per cent in 1961.

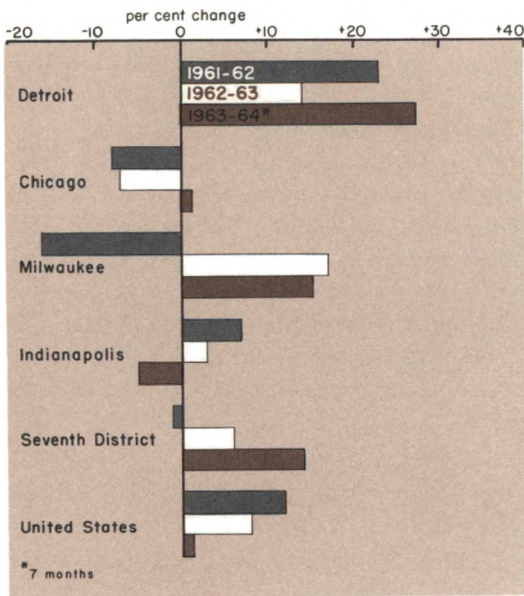
Mortgage credit expansion continues

The 1961-63 upswing in housing construction in the United States has been accompanied by a large increase in mortgage debt. From December 1960 to December 1963, mortgage debt on one-to-four family nonfarm homes rose 41 billion dollars, an increase of 29 per cent.

Since 1960, savings and loan associations have expanded their mortgage holdings by approximately 13 per cent each year, a rate exceeding any other major group of mortgage lending institutions. With loans increasing an additional 2 per cent in the first quarter of 1964, the associations' share of total mortgage loans outstanding reached 44 per cent, compared with 39 per cent in 1960.

In contrast, the share of total home mortgages held by life insurance companies dropped from 18 to 15 per cent during the same period, as acquisitions by these firms grew less rapidly than the total supply of mortgages. Mutual savings banks recorded a small increase in their share of home mort-

Housing permit activity has been stronger in the District than in the nation this year



gage outstandings, moving up from 13 per cent in 1960 to 14 per cent in the first quarter of this year.

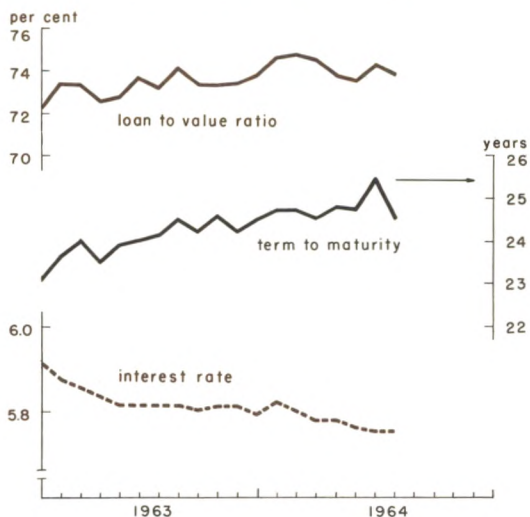
The proportion of total home mortgages held by commercial banks did not change between 1960 and the first quarter of 1964, remaining at 14 per cent. Banks increased their mortgage holdings slightly in 1961, and then, as time deposits increased rapidly, they expanded their acquisitions at a pace faster than the average for all mortgage investors in 1962 and 1963.

A gradual decline in mortgage interest rates has paralleled the large increase in mortgage debt. Nationally, the Federal Housing Administration reported that the average interest rate for conventional mortgages on new homes peaked at 6.30 per cent in mid-1960 and then decreased to 5.95 per cent in June 1961, 5.90 per cent in December 1962, 5.80 per cent in May 1963 and has remained unchanged since. Rates for mortgages on used homes have followed a similar pattern.

In contrast, yields on long-term government bonds have been trending upward since 1961. They averaged 3.90 per cent in 1961, 3.95 per cent in 1962, 4.00 per cent in 1963 and reached 4.14 per cent in August of this year.

More inclusive information on conventional contract mortgage interest rates and other loan terms has been available from the Federal Home Loan Bank Board since December 1962. These data also indicate a drop in mortgage interest rates in the second half of last year. Furthermore, they indicate a slight further easing of rates in 1964 as, for example, a slight decline from 5.80 per cent

Mortgage terms on new homes have eased since last winter



in December 1963 to 5.76 per cent in July 1964 for new home mortgages. The pattern was similar for mortgages on used homes.

While mortgage rates have declined, other mortgage terms also have eased. In particular, maturities have lengthened and the average size of loans relative to the value of the property has increased. For example, national average maturities on new home mortgages increased gradually from 23.3 years in December 1962 to 24.5 years in July 1964. Maturities for used home mortgages followed a similar pattern. National average loan-to-value ratios on new home mortgages rose from 72.0 per cent in December 1962 to 74.8 per cent in February 1964 and then declined to 73.9 per cent in July.