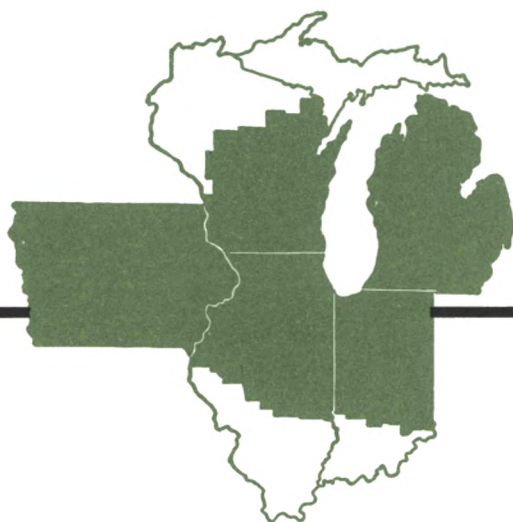


# Business Conditions

**1968 February**



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# Trends in banking and finance

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## The 1968 starting line

The year begins with economic activity high and rising rapidly. This is reflected in such measures as industrial production, employment, and consumer spending. Gains are being made in response to strengthening of basic demand, the gradual fading of the effects of last fall's strikes, and the anticipation of possible strikes later this year. Inventories of materials and merchandise are rising and substantial additional stockpiling is expected, especially of steel and steel products. Spending by the federal government, though not expected to rise as fast as last year, remains stimulative, and outlays for state and local projects continue a rapid rise.

Financing projected levels of activity—at least in the first half of 1968—promises to require at least as much credit as last year. How much of this will be reflected in the growth of bank credit will depend largely on two factors: (1) the deposit expansion that

will be permitted to take place through additions to bank reserves by the monetary authorities and (2) the extent to which the banks compete successfully with market securities and obligations of nonbank financial institutions both in the procurement and the placement of funds.

Last year's slackened loan growth and rapid reserve expansion provided some cushion for meeting potential loan demand in the months ahead, but banks have little leeway in boosting their total credit independent of their ability to expand deposits. Federal Reserve aims call for the provision of reserves to support money and credit expansion as needed to facilitate growth of production and consumption. But the system must also undertake to keep spending from rising faster than potential output. A return toward price stability must be a high priority objective in 1968 not only for domestic reasons but be-

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cause of the adverse effect of further inflation on the balance of payments and the position of the dollar as a world currency.

If demand is excessive, as suggested by the price increases already taking place, some expenditures will have to be curtailed or postponed. One way of doing this would be to boost taxes, thereby slowing the growth of disposable income. Another would be to restrain spending by holding a tight rein on the availability of credit. Still another would be to reduce or postpone some government spending. Even with the assumption that taxes will be raised in the current session of Congress, some slowdown from last year's record growth in bank credit seems appropriate. Should demands for credit be strong enough to push market rates well above the interest ceilings on time deposits, many banks would again find their ability to acquire loanable funds severely limited.

### **Where district banks stand**

The charts on pages 4 and 5 show the changes in loans, investments, and deposits at Seventh District member banks in the past three years. On the basis of the relationship between their loans and deposits, these banks appear less able to accommodate the credit demands likely to be associated with a further upsurge in business activity than they were two years ago. Whatever leeway they have stems from developments last year, when an expansive monetary policy allowed a record 11.5 percent growth in deposits—more than twice the 1966 gain—and the posture of monetary policy in the months ahead.

Investments rose faster than loans last year, with U. S. governments up 8 percent and other securities, including municipal and federal agency issues, up 21 percent. Much of the increase in governments came in the second half of the year, when the Treasury

was borrowing heavily to finance its large deficit. Holdings of governments rose most at large city banks, and about half of their net acquisitions consisted of Treasury bills.

Government securities provide a reservoir of liquidity, because they can be sold or allowed to run off when funds are needed for loans. However, several factors limit this flexibility in the current environment.

- A large part of the Treasuries are pledged as collateral for public deposits. Holdings are currently only about a billion dollars above the "rock bottom" levels reached in mid-1966.

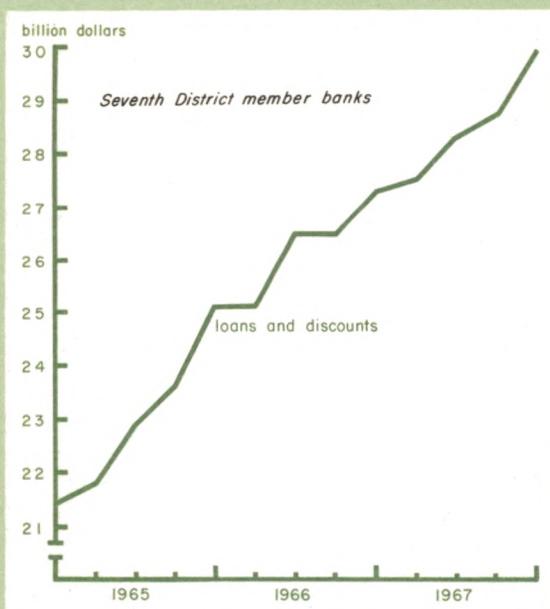
- Because of the sharp increase in interest rates in the past two years, large capital losses would accrue from the sale of most intermediate and long-term issues now in bank portfolios.

- Little net reduction in bank holdings of Treasury securities can be expected in the face of the forthcoming volume of new issues for which banks will be important distribution channels.

Banks continue to acquire large amounts of municipal and agency securities. The total amount of these securities in bank portfolios has nearly tripled since the end of 1960. They now make up about a sixth of the earning assets of Seventh District member banks. The steady climb in bank holdings of municipal issues reflects not only the steady increase in the supply of these securities but also their favorable after-tax yield compared with yields on direct Treasury obligations. While many state and local securities are long term and not readily marketable, about 30 percent of last year's increase at large banks in leading cities was in tax warrants and other short-term notes and bills that will provide an inflow of funds in the near future.

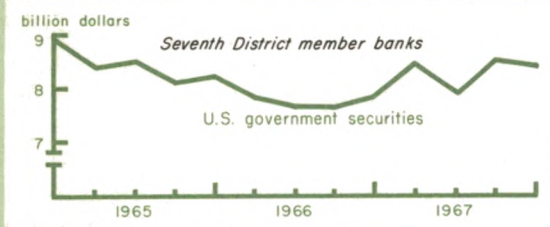
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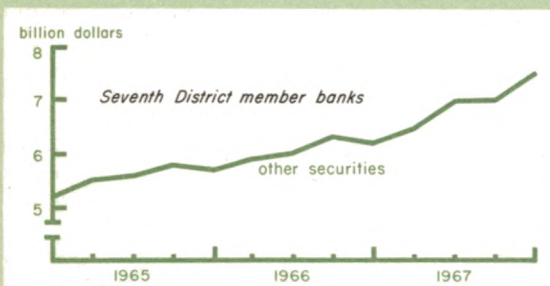


### Seventh District member banks

**LOANS** account for most of the growth of bank credit. But expansion was not as fast in most of 1967 as in the 1965-66 period of strong demand that accompanied sharply rising economic activity. For 1967 as a whole, total loans of district member banks rose 10 percent compared with a gain of 9 percent for all commercial banks in the nation.



**U. S. GOVERNMENT SECURITY** holdings show an uptrend since mid-1966 but holdings are still only moderately higher than two years ago. Aside from the amounts held for various collateral purposes, changes in holdings largely reflect the timing of Treasury financings. About the same proportion of governments maturing in one year were held nationwide by member banks in mid-1967 as two years before—43 percent.



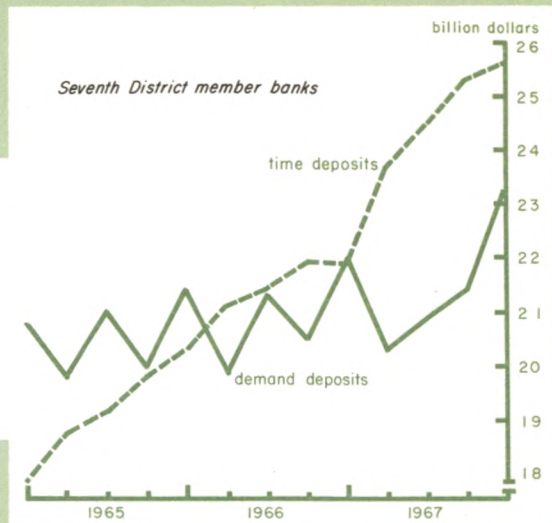
**MUNICIPAL and GOVERNMENT AGENCY SECURITIES** continue to attract bank funds. District member banks acquired \$1.3 billion of these issues in 1967—an increase of 20 percent. These securities constitute 16 percent of earning assets of the banks. In mid-1967, about 20 percent of state and local securities held by all member banks in the U. S. had maturities within one year.

Note: All are end-of-quarter figures except reserves which are quarterly averages of seasonally adjusted monthly figures.

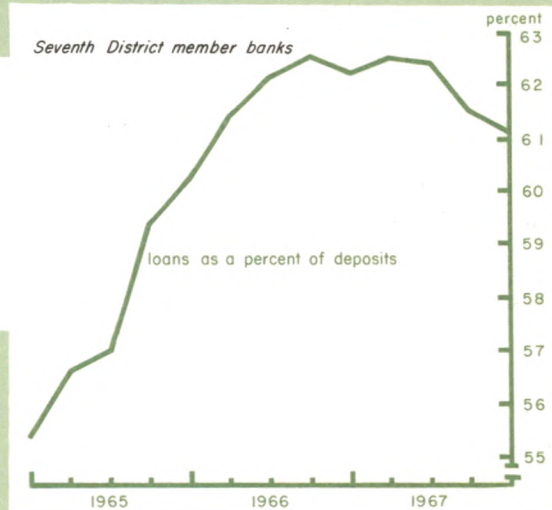


## begin 1968 in high gear

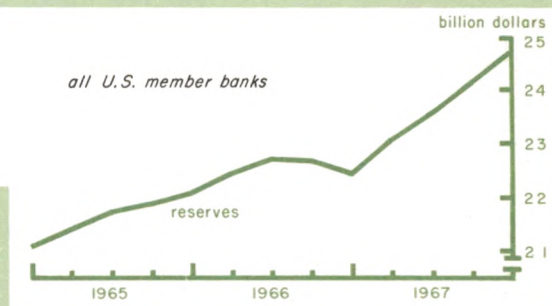
**DEPOSIT GROWTH** resumed at a rapid pace in 1967 after the easing of monetary policy. Time deposits provided the major thrust. Total deposits of district member banks rose 11 percent during the year, but as market interest rates rose toward year-end, inflows of time deposits again leveled off.



**BANK LIQUIDITY**, measured by the loan-to-deposit ratio, improved modestly in 1967 as deposits rose faster than loans. Large banks accounted for all of the improvement, mainly through aggressive sales of negotiable CDs. At country banks, the ratio was virtually unchanged in late December from the year-earlier level.



**BANK RESERVES** were supplied by the Federal Reserve system at a 10-percent rate of growth last year, following a contraction in the second half of 1966 and an average annual rate of growth of about 3 percent from 1957 to 1966. The rapid expansion in reserves helped support renewal of vigorous economic growth.



—continued from page 3

Meanwhile, loans, which now comprise more than 60 percent of all district member bank deposits, have continued to rise, though not as fast as in the 1965-66 boom. Commercial and industrial loans rose more than usual in the first half of 1967, largely because of corporate borrowing to meet the accelerated tax payment schedule. But later in the year, business use of bank credit weakened, at least in relation to expected demands, until very near the end of the year. The slower growth of bank loans to business—in the face of rising economic activity—reflected the large amount of funds raised by corporations in the capital markets—more than 60 percent greater than in the same period in 1966.

In the year as a whole, city banks of the district reported a total gain of 11 percent in business loans, compared with 14 percent in 1966 and a spectacular 24 percent in 1965. Expansion in consumer and real-estate loans also slowed last year. Nevertheless, the total

increase in loans at district member banks amounted to about \$2.5 billion last year and was larger than in 1966.

### Deposit trends

Although demand deposits accounted for part of last year's deposit growth, a resurgence in time deposits was mainly responsible. The growth of time deposits had leveled off in 1966, largely because yields on money market securities rose above the ceiling rates banks were allowed to pay on large negotiable time CDs (certificates of deposit).

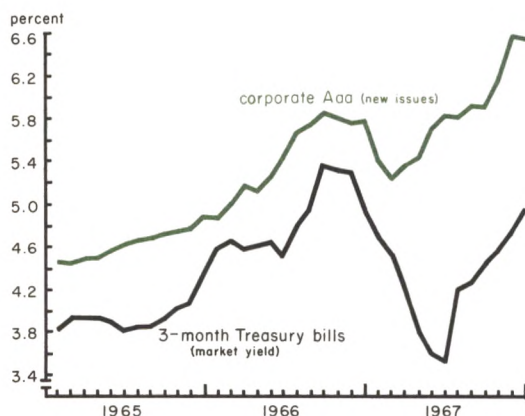
With the shift to expansionary monetary policy, yields declined and CDs again became competitive. By the end of November, city banks in the district had boosted the volume of CDs to about a fifth more than their mid-1966 peak.

These banks also had sizable gains in smaller time certificates and open account time deposits but small declines in passbook savings on which they could pay only 4 percent interest.

Most of the inflows of new savings were apparently in the form of certificates. Many banks, small and large, sought to attract funds by offering certificates with various denominations, maturities, and renewal provisions at rates above that for passbooks. But by year-end, nearly all large banks were offering, on all types of time and savings deposits, the maximum rates allowed by regulations. A large number of small banks, however, still had room to raise their rates. In the market for large negotiable CDs, only maturities of less than three months were still competitive with yields on competing money-market securities.

Deposit gains, more than the weaker loan demand, were responsible for the reduction in loan-to-deposit ratios in 1967. Total loans of Seventh District member banks were 61.1

### Spreads between long and short-term yields were unusually wide in 1967





percent of total deposits at the end of December—down only 1.5 percentage points from the peak reached in the fall of 1966. Moreover, all this decline was due to large banks in major cities, where individual ratios still range up to 80 percent or more. Loans at smaller banks continued to creep higher in relation to deposits.

Within loan portfolios, however, are some important sources of liquidity. Total loans include holdings of bankers' acceptances, overnight loans to other commercial banks (federal funds), and loans to security dealers. In the last six months, large district banks have been fairly heavy net sellers of federal funds. Many small banks have also used this market as a temporary outlet for short-term money.

Decisions about the reinvestment of these funds are made daily. Repayment of funds borrowed to meet tax liabilities—a major reason for last year's business borrowings—will also provide funds to meet new loan demands. Considering these factors, liquidity has undoubtedly improved more than the relatively small shrinkage in loan-deposit ratios indicates.

Nevertheless, the banking system as a whole cannot expand total credit by liquidating short-term assets. It can only change the composition of credit. New loans can be made as outstanding credits mature or as they are sold, forcing the issuers of the assets liquidated to obtain financing from investors other than banks—probably at higher rates.

Clearly, deposit growth is the basic source of bank credit. And while individual banks can acquire funds by bidding them away from other banks, the banking system as a whole can gain deposits (aside from slippages due to excess reserves and shifts among banks with different reserve requirements) only to the extent the supporting reserves are pro-

vided by the Federal Reserve System. The reserve base of the banking system, after rising only 2 percent in 1966, was up more than 10 percent last year, accommodating concurrently large gains in deposits and credit.

### **Monetary policy factors**

These relationships point to the critical importance of monetary policy in the banks' ability to meet credit demands. In the first half of 1967, reserve expansion was intended to stimulate renewed growth in the economy and offset the depressing effects of the massive inventory adjustment then in process.

Reserves continued to be provided rapidly during the second half, despite developing labor shortages and upward price pressures. But rising interest rates indicated that even the large volume of funds supplied was falling short of credit demands. Several factors mitigated against cutbacks in the rate of reserve growth. These included some doubts about the underlying strength of the economic expansion, concern that higher interest rates would be unsettling to international exchange markets and would again have unfavorable repercussions on housing construction, hopes for greater restraint on federal spending and an increase in income taxes, and a need to provide market stability for the very large volume of Treasury borrowings. Before year-end, however, and following promptly on the heels of the devaluation of the British pound, increases in the discount rate and, beginning in January, increases in the reserve requirements at large banks signaled the Federal Reserve System's growing concern with inflation and the prospects of excessive demand in 1968. The growth in reserves and bank credit was much reduced in December.

### **January visibility low**

Interest rates on marketable securities de-

clined substantially in the first half of January even though prospects for further expansion in income and spending appeared increasingly firm. Investors stepped up their purchases of securities, and dealers' stocks declined. Optimism mounted that policy actions, either already announced or expected, would be effective in holding credit demands to amounts commensurate with the flow of savings under conditions of a more moderate rate of monetary expansion. But because of seasonally strong investment demand, January readings provide notoriously unreliable clues to forthcoming trends. Unless there is marked moderation in the economy's growth, the respite could be short lived.

What are the implications for the banks? Probably some strains are ahead, especially in the first quarter. In addition to the \$8 billion the Treasury is expected to raise before the end of March—much of which banks will acquire initially—many of the large banks also expect substantial demand for business loans to finance larger inventories, meet tax payments, and in some cases to avoid paying the high rates on borrowings in capital markets.

Banks appear prepared to accommodate some increase in loan demand although the adjustments required for them to make such loans have some impact on short-term money markets. Their maneuverability appears limited, except as reserves increase further. If loan demand increases to a great extent, either a significant cutback in reserve growth or a rise in yields on money-market securities above the maximum rates authorized on CDs could force tightening of bank lending policies.

There are, however, strong reasons for as-

suming that any such strains will be moderate. In the first place, credit demands may not be as great as some banks expect. Many corporations that sold bonds last year can draw on those funds in the months ahead. Temporary investment of the proceeds was partly responsible for short-term rates falling well below long rates last year. Furthermore, the decline in yields in the bond market since mid-November has both dampened investors' inclinations to wait for still higher yields and encouraged the marketing of issues that had been postponed earlier. In the second place, the implementation of monetary policy—even a more restrictive policy if that proves necessary—will be designed to prevent net liquidation of bank credit and avoid unduly severe strains on financial markets.

And finally, there is evidence that banks and other depository institutions are somewhat less vulnerable to the loss of funds through the attraction of higher yields on marketable securities than they were two years ago. This has resulted from a more widespread recognition by depositors of the importance of the reciprocal relationship between banks and business and, perhaps most important, the smaller proportion of highly interest-sensitive money now placed with financial institutions. Since year-end, neither personal savings funds nor CD money have flowed out in the amounts many institutions had expected.

To the extent there may be financial strains ahead, they seem likely to be greatest in the short-term market. A narrowing of the recently wide spread between long and short-term rates would be more in keeping with the normal pattern in a period of sharply rising economic activity and strong credit demand.



## A reappraisal

# The world food problem and the U. S. farmer

The adequacy of world food supplies has been a matter of concern for years. The decline in commodity stocks and world grain production has caused many observers, mindful of expanding population, to call for all-out production to eliminate the "world food shortage." In response, the government relaxed some of its programs in 1967, farmers sharply expanded production, and grain prices dropped. The result has been that many now question whether there really is a world food shortage.

It is hard to measure food consumption levels in most areas of the world. Many countries do not know the number of their populations or how fast they are growing. Detailed information on production is often even more fragmentary. Nevertheless, most specialists on the subject would argue that a significant part of the world's population is suffering from malnutrition. But that does not mean there is a strong economic demand for food or that American farmers will be called on to increase production.

### Population

Demographic changes, and especially population increases, contribute most to the food problem. World population was about 1.5 billion in 1900—roughly twice what it had been two centuries before. In little more than half a century, the population doubled again; and it is now estimated at about 3.5 billion. The increase has not come uniformly through-

out the world, but largely in countries that can ill afford the added burden.

While definitions differ, countries are commonly grouped according to levels of per-capita income—those with annual incomes of roughly \$500 or more being classified as *developed* and those with incomes less than \$500 being classified as *developing*. More than two-thirds of the world population is in developing countries. All of these countries are probably experiencing population growth rates estimated at more than 2 percent a year. The rapid increase in population in these countries has resulted largely from a marked reduction in their death rates. In many of these countries, the mortality rate per thousand people has been reduced more than half in the last 20 years—due largely to wider application of public health and sanitation practices. The death rate in one Asian country reportedly dropped 40 percent in the first year after the introduction of DDT.

Birth rates have always been high in these countries, compared with developed countries, and have changed little with the decline in death rates. As a result, the average rate of population increase in these countries is estimated at about 2.4 percent a year compared with less than 1 percent before 1945.

Although the developed countries had high death rates as well as high birth rates in the early stages of their development, birth and death rates have tended to decline together. Because of this, population increases for these

countries have not averaged more than 1.2 percent a year for any extended period. At present rates of population growth, the time required to double the population in most developing countries is 18 to 27 years. By contrast, it is 55 to 88 years in most developed countries.

### Production

Most countries have achieved sizable increases in agricultural production since the mid-1950s. World food production has increased more than a third in the last decade. Although the rate of growth in food production varies between countries, both developed and developing countries have increased their outputs at about the same rate for the past decade—2.4 percent a year. Of the 55 countries belonging to the United Nations Food and Agriculture Organization, only three

have shown a downward trend in food output since the mid-1950s—Sweden, which has reduced production as a matter of policy, and Algeria and Uruguay. At least 11 countries were able to expand output at an annual rate of at least 4 percent, and another 16 increased output by more than 3 percent. The United States and some of the other developed countries with policy aims of keeping production in line with relatively slow rises in demand were among those with the lowest rates of production increase.

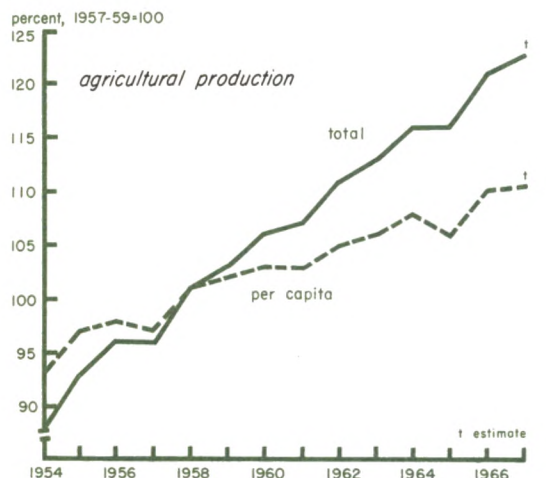
### Imbalance—per-capita production

On the average, per-capita food production in developing countries has remained about constant in recent years, with these countries doing little more than keeping up with their rapid increases in population. Meanwhile in developed countries, per-capita production has increased about 12 percent.

Food production in countries of South Asia, North Africa, and the Caribbean appears to have actually fallen behind population growth, resulting in lower consumption per person. In South Asia—particularly in India and Pakistan—the drop appears to be only the temporary result of unfavorable weather in 1965 and 1966. These countries were making slow progress in boosting per-capita grain production until the 1965-66 drought. The record harvest forecast for 1967-68 may allow resumption of the sub-continent's long-run upward trend in per-capita production. Because India and Pakistan loom so large among the developing countries—together they account for more than a third of the population of such countries—their progress (and setbacks) in food production greatly influence views of the aggregate.

Other developing countries have continued to make progress—some in sizable steps. Over roughly the past decade, for example,

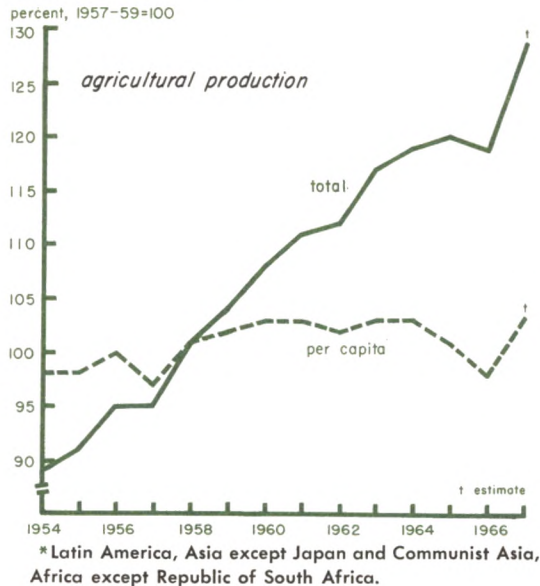
**Both total and per-capita production show rapid advances in developed countries\***



\* North America, Europe, USSR, Japan, Republic of South Africa, Australia, and New Zealand.



## Production barely keeps pace with population growth in developing countries\*



production in Southeast Asia and Mexico increased far faster than population. And modest gains were made in East Asia, East Africa, and Central America. Most South American countries, however, just about kept pace with the population expansion.

### Looking ahead

Future food requirements are hard to predict, largely because population levels have not been accurately determined. Not only are estimates of current population growth unreliable—or simply not available—but forecasts vary widely.

The United Nations has made three sets of projections of population to the year 2000. Each is based on a different assumption. Projections for major areas of the world at recent growth rates would result in a world population of nearly 7.5 billion—more than

twice the current population in little more than 30 years. The medium projection would indicate a population just over 6 billion. An extension of the 1940-60 growth rate indicates a population of about 5 billion—still more than a two-fifths gain.

Others are more optimistic about the possibilities of reducing birth rates. They cite growing approval of family planning, aroused political leadership to promote fertility control programs, and vastly improved technological means of birth control. Also, progress is believed to be slackening in achieving continued substantial reductions in mortality rates. Because of these factors, they forecast a population of about 4.5 billion in 2000—less than a third more than in 1965.

All these projections indicate sizable increases in food requirements. But food requirements for diets that are nutritionally adequate must be distinguished from requirements to meet economic demands. To bring the diets of the world's population up to some acceptable standard of nutrition, there must be an "effective demand" for the food—the means of buying the food must be available. The increase in food production needed to correct nutritional deficiencies would probably be much greater than the increase needed to meet economic demands resulting from rising population and incomes.

The Department of Agriculture estimates that two-thirds of the world's population live in countries with national diets that are typically inadequate in calories, protein, or fat. The diets of people in these areas in 1959-61 were believed to be 900 calories a day less than the diets of people living in more developed countries and 300 calories short of minimum nutritional standards. The daily consumption of protein was a third less than in countries with adequate diets, and the rate of fat consumption was short two-thirds. In

terms of grain, another 25 million metric tons would have been needed in 1959-61 to eliminate the calorie deficit in the developing countries, excluding communist Asia. That would have been 16 percent of consumption.

According to the President's Science and Advisory Committee on the World Food Problem, for the nutritional deficits to be eliminated, per-capita consumption of food in developing countries would have to be increased more than 1 percent a year for the next 20 years. This, with the population of these countries growing about 2.5 percent a year, means the food required for these countries would more than double by 1985.

If developing countries continue to expand their food production at the rates of recent years—about 2.7 percent a year—they will need net imports of about 95 million metric tons in 1985 to meet projected grain requirements. That would be about a fifth of the total projected grain requirements, compared with a tenth that these countries imported in 1964-65.

If, however, these countries could boost their production 4 percent a year (which is not likely), their projected net import requirements would drop to about 15 million tons—about the same as in 1959-61 but less than the 24 million imported in 1964-65.

Department of Agriculture estimates of food needs based on economic demands are substantially less than needs based on nutritional requirements. If developing countries can maintain their historical rates of increase in grain production, by 1980 they will need to increase their imports to between 34 and 38 million tons. But with only moderate improvements in production, they will need to import slightly less than 30 million tons.

While both projections provide some increase in per-capita consumption, both fall far short of achieving minimum nutritional

standards. The first set of projections allows only a 0.3-percent annual increase in the rate of per-capita consumption. The second implies an increase of 0.7 percent. Both are well below the 1-percent increase the President's advisory committee believed necessary to correct nutritional deficiencies in 20 years.

The calorie gap could be closed only if the rate of increase in grain production could be accelerated to 4 percent a year by 1975 and held at that rate. Because of the extensive increase in agriculture resources required for such a production gain, the Department of Agriculture does not consider such an achievement as likely.

### **Implications for the U. S. farmer**

American agriculture has the capacity to produce far more than it does now. There is no doubt that it could contribute significantly to the food needs of developing countries. Until recently, more than 50 million acres—about a fifth of the acreage harvested in 1967 and about a third of the grain acreage harvested—was withheld from production under various government programs. A large part of this acreage was quickly returned to production in 1967. Given additional time and incentive, farmers could return substantially more to production. There is also an estimated 260 million acres not now in cropland that could be brought under cultivation if required. The technological contributions that have boosted yields will doubtlessly continue and certainly could be stimulated.

But it is economic demand, not the need for food, that will induce greater production. As compassionate as farmers may be, they cannot shoulder the costs of production merely for the satisfaction of feeding the undernourished. Someone must pay. Either the prices consumers pay for farm products must be high enough to make production



profitable for farmers or some third party must pay the costs. This is true for international concessional sales as well as for normal commercial operations within countries and between them.

The Department of Agriculture study of economic demands implies that the world (and especially the United States) will probably continue to have excess agricultural capacity by 1980. How much of that is used will depend on the prospects for production

and trade and on government policies.

The study also indicates that, if the United States were to continue pursuing supply-management policies to balance world grain supplies and demands at prices close to the average of the past three years, it could maintain or even slightly increase its historical share of world trade through 1980. Only about 165 million harvest acres of grain would be required, however—about the same as last year.

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## Gold: Legacy of a bygone era

In his State of the Union message, the President asked Congress to remove the requirement that Federal Reserve Banks maintain a 25-percent gold-certificate reserve against Federal Reserve notes.<sup>1</sup> These notes account for almost all U. S. currency in circulation. If the request is granted, Congress will have broken the last tie between gold and the domestic use of the dollar.

The link between gold and the international use of the dollar will remain intact, however. The President reiterated that the United States will continue to maintain the current price of gold at \$35 an ounce.

Coming when the U. S. gold stock is the lowest since the 1930s and in the wake of the recent devaluation of the British pound, the President's proposal has revived public interest in the function of gold in our monetary system and, in some cases, possible concern over the future soundness of our currency.

Gold has served as money or provided the basis for defining the monetary value of currencies longer than any other material. The use of gold coins, taken up from the Asians by the Greeks and Romans, had spread throughout most of Europe by the fourth century B.C. The need to finance ever-larger units of business finally made payment by coin impractical, however, and gold was replaced by paper currency that, except in times of crisis, could be converted to gold at a fixed rate of exchange.

With the growing commercialization and industrialization of Europe, the needs of rapidly expanding economies soon outran the ability of gold to provide a smoothly expanding monetary system. Crises in which the convertibility of paper currency was restricted became more frequent. Periods of little or no growth in the gold supply were followed by periods of rapid expansion as new sources of gold were discovered. These often violent fluctuations in the supply of gold were reflected in equally violent changes in prices, and consequently, the value of money.

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<sup>1</sup>The President also requested freeing the gold the Treasury maintains in a small redemption fund against two old currency series.

In the mid-1800s, the British banker-economist, Walter Bagehot, declared that “money does not manage itself.” The era of gold as the sole determinant of the amount of money in circulation began drawing to a close.

### **Gold and the dollar**

The earliest coins circulated in the United States were foreign coins, mostly gold, brought from Europe. An independent monetary system was created with passage of the Coinage Act in 1792. This act established the dollar as the basic U. S. monetary unit and fixed its content at  $24\frac{3}{4}$  grains of fine gold. The value of the dollar was based on the world price of gold—\$19.39 a troy ounce (480 grains).

Congress changed the gold content of the dollar slightly in 1834 and again in 1837. The last change set the dollar-price of gold at \$20.67 an ounce. It remained at that price for almost a hundred years.

Until the Civil War, the money supply comprised various coins and paper notes issued by state-chartered banks. The bank notes could be converted into gold at the issuing bank. To discourage holders from exchanging their notes for gold, some banks in newer sections of the country were located in sites “more convenient for wildcats than for humans”—hence “wildcat banking.”

The federal government issued its first paper currency during the Civil War. Because these wartime notes were printed on green paper (which became the traditional color of currency in this country) and were not backed by gold, they were often called “greenbacks.”

In 1864, Congress passed the National Banking Act. This act authorized national chartered banks and established standard notes that could be issued by these banks. The

new notes replaced the notes of varying color, size, and value issued by state banks. The new national banks were not required to convert these notes into gold, however, until 1879, when the United States returned to the gold standard. A variety of paper currency circulated concurrently and interchangeably with gold and other coins from 1879 to 1933.

The Great Depression, which made clear the need for government to participate more actively in economic policy, stimulated consideration of basic changes in the mechanics of providing money. In 1934, after allowing the price of gold to fluctuate more or less freely for almost a year, the President used power granted him by Congress to establish a new price for gold. Residents of the United States were also prohibited from holding gold in this country for monetary purposes—a prohibition that was extended in 1961 to include U. S. citizens holding gold abroad.

The gold content of the dollar was reduced to  $13\frac{5}{8}$  grains and the dollar-price of gold was increased to \$35 an ounce. Unlike the prices of other goods, the price of gold has remained at this level—through war and peace, inflations and recessions—for more than 30 years.

For all practical purposes, gold ceased to exist as a monetary metal in the United States in 1934. The only remaining connection between gold and the domestic dollar is largely a carryover from the early days of domestic convertibility. That is the requirement that Federal Reserve Banks maintain reserves in the form of gold certificates equal to 25 percent of their notes outstanding.

The United States was still on a gold standard when the Federal Reserve Act was passed in 1913, and currency was readily convertible into gold. Because Federal Reserve Banks both issued currency and held the reserves of member banks, gold reserve



requirements were imposed equal to a percentage of their note and deposit liabilities. The requirement against notes was set at 40 percent and against deposits at 35 percent. The relevance of these requirements changed considerably when the United States ended domestic gold convertibility in 1934. At the same time, the Federal Reserve Banks exchanged their gold for special gold certificates to conform with the ban on domestic gold holdings by everyone but the U. S. Treasury.

Since 1934, the gold requirement has placed a theoretical upper limit on the expansion of the supply of money. But in practice, the Federal Reserve has regulated the supply of money according to the needs of the economy. In 1945, when it appeared that the gold requirement might prevent adequate expansion of the money supply to finance military expenditures and maintain aggregate levels of income and employment during the adjustment to peacetime conditions, Congress

reduced the cover to a uniform 25 percent on notes and deposits. Again, in 1965, when, as the result of continuing large deficits in the U. S. balance of payments, the diminishing supply of gold approached the level required as reserves, Congress removed the gold reserve requirement on deposits altogether.

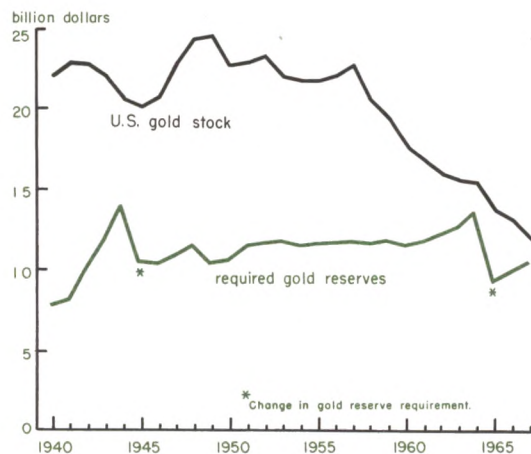
Since that time, the continued deficits in the balance of payments and the unsettled international financial situation (which has directed most newly mined gold into private overseas hoards rather than into official government stocks) have further reduced U. S. holdings of gold. The gold stock has slipped to only slightly more than the amount required to satisfy the 25-percent reserve requirement on currency. As a consequence, Congress again faces the need to reduce or eliminate this reserve requirement.

### Gold and purchasing power

Gold backing does not guarantee the soundness of a currency—the stability of its purchasing power. Countries operating under the gold standard had both severe inflations and deflations. The most severely prolonged peacetime inflation in U. S. economic history occurred between 1897 and 1914. Prices rose 40 to 50 percent as new discoveries of gold were made in Alaska and Colorado and a new recovery process increased gold production at old mines. There have been severe deflations, on the other hand, when the supply of gold was insufficient to support the needs of rapidly expanding economies or as people sought, for one reason or another, to convert their paper money to gold on a large scale. For example, prices declined by more than 25 percent between the beginning of the Great Depression in 1929 and 1933.

Because of the difficulty of pacing the supply of gold to the demand for funds, most countries have either eliminated the link be-

### Gold stock has declined steadily, approaching amount required as reserves



tween gold and their currencies or removed its effectiveness. As in the United States, the monetary authorities of these countries try to provide a flow of money consistent with price stability and the level, or desired level, of domestic economic activity.

### **Gold and international payments**

While gold has long ceased to play a significant part in the internal monetary systems of most countries, it continues to hold a prominent position in the system of international payments.

The present international monetary system—the so-called gold exchange standard—is based on the free international convertibility of the dollar into gold at the fixed price established in 1934. This price, \$35 an ounce, was formally incorporated into the present system by congressional approval of the Articles of Agreement of the International Monetary Fund in 1944. Under this agreement, the United States undertakes to maintain the fixed dollar-price of gold by buying all the gold offered to it at that price and selling gold for dollars to foreign official buyers. While no other country undertakes to sell gold at a fixed price in its currency, the other countries agreed to maintain the exchange value of their currencies relative to the dollar. By these arrangements, the international system of payments was tied to gold.

Foreign countries hold both gold and dollars as international reserves. Much of the international payments are made in dollars, even in instances where an American is not a party to the transaction. Also, because dollars are maintained at a fixed value relative to gold and because dollars can be invested in earning assets while gold reserves yield no current income, countries find it profitable to hold reserves in dollars.

If foreign holders of dollars were no longer

sure that the United States would accept dollars in exchange for gold at a fixed price, moves to acquire gold would probably increase and world liquidity, measured in terms of gold and dollars, would decline. This, in time, could have a seriously adverse effect on international trade and investment.

Against this background, the President has asked essentially for both an increase in the amount of gold available to meet any demands of foreign holders of U. S. dollars and for a reduction in future deficits in the balance of payments—deficits that give rise to additional foreign holdings of dollar claims.

Elimination of the gold reserve requirement against Federal Reserve notes would make it clear that the entire U. S. gold stock is available to support the international value of the dollar. The proposed change does not affect the domestic value of the dollar. That value—the purchasing power in domestic markets—is based on the productive capabilities of the United States and the total supply of money in circulation.

As has been the case within countries, the financial needs of trade between countries are expanding faster than the supply of gold. Therefore the monetary authorities of many countries are cooperating in efforts to establish a system that would supplement the use of gold and dollars as international reserves. At a meeting in Rio de Janeiro last fall, member nations of the International Monetary Fund approved the outline of a plan to introduce a new reserve currency known as special drawing rights. The IMF would guarantee the value of these new reserves, called SDRs.

While details of the plan remain to be worked out, approval of the outline may have inaugurated a new era of international financial cooperation in which the role of gold will continue to diminish.