A review by the Federal Reserve Bank of Chicago

Business Conditions

1968 August

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Direct access to Federal Reserve credit is one of the major benefits of membership in the Federal Reserve System. The district reserve banks' discount windows provide member banks with a convenient means of borrowing reserves to cover temporary reserve deficiencies or to meet credit needs arising from unusual local developments or strong seasonal requirements in their areas. Also, in the event of sudden public demand for large holdings of cash, the discount facilities stand as a source of ultimate liquidity.

Although the availability of credit for these purposes is important to all banks and to the stability and viability of the entire financial system, the volume of reserves generated through member bank borrowing is actually very small. Seldom is it 5 percent of the total. Also, there are great differences in the use banks make of the discount facilities. Most member banks have not turned to their reserve banks for loans in several years, and many others have done so only rarely.

The extent of the differences between banks and some indication of how borrowing patterns change with conditions of the credit markets are shown by the record of lending to Seventh District member banks over the last two and a half years.

The borrowers

Fewer than 200 of the approximately 990 member banks in the Seventh Federal Reserve District borrowed from the Federal Reserve Bank of Chicago last year. In 1966, a year when most banks found it harder to meet demands for credit, about 270—slightly more than a fourth of the district members—borrowed at the window. There was much the same difference across the nation.

Reserve city banks—large banks in large cities—use the discount window much more than country banks. Two-thirds of the district's 25 reserve city banks borrowed at the discount window last year, and nearly all of them did the year before. But only a fourth of the country member banks borrowed in 1966, and less than a fifth in 1967.

Because large city banks usually manage their money positions more closely than most country banks and rely more on the money market in meeting day-to-day needs for funds, the city banks are generally more vulnerable to short-term pressures. This may account in part for the more widespread use of the window among reserve city banks. Most country banks are too small for active participation in the money market, where most financial transactions are large.

For the most part, the same banks tend to borrow year after year. Of the 180 country banks that borrowed from the Federal Reserve Bank of Chicago in 1967, some 85 percent had also borrowed the previous year.

Of the many country banks that hardly ever borrow, some maintain enough excess
### Member bank borrowing from the Federal Reserve Bank of Chicago, 1966 and 1967

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<tbody>
<tr>
<td>Number of member banks</td>
<td>26</td>
<td>25</td>
<td>369</td>
<td>364</td>
<td>153</td>
<td>149</td>
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<tr>
<td>Percent that borrowed during the year</td>
<td>92</td>
<td>68</td>
<td>26</td>
<td>18</td>
<td>14</td>
<td>11</td>
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<tr>
<td>Aggregate amount per average reserve period (million dollars)</td>
<td>86</td>
<td>37</td>
<td>15</td>
<td>6</td>
<td>3</td>
<td>2</td>
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<tr>
<td>Average number of periods banks borrowed (per bank)</td>
<td>18</td>
<td>7</td>
<td>6</td>
<td>4</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>Average length of longest span of borrowing (reserve periods)</td>
<td>7</td>
<td>2</td>
<td>4</td>
<td>3</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Percent of borrowers with ratio of borrowing to required reserves of:</td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Over 40 percent</td>
<td>—</td>
<td>10</td>
<td>14</td>
<td>—</td>
<td>13</td>
<td>21</td>
</tr>
<tr>
<td>30 - 40 percent</td>
<td>12</td>
<td>6</td>
<td>7</td>
<td>6</td>
<td>14</td>
<td>6</td>
</tr>
<tr>
<td>20 - 30 percent</td>
<td>12</td>
<td>18</td>
<td>15</td>
<td>14</td>
<td>18</td>
<td>31</td>
</tr>
<tr>
<td>10 - 20 percent</td>
<td>29</td>
<td>12</td>
<td>45</td>
<td>34</td>
<td>27</td>
<td>25</td>
</tr>
<tr>
<td>Under 10 percent</td>
<td>42</td>
<td>65</td>
<td>23</td>
<td>32</td>
<td>41</td>
<td>25</td>
</tr>
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1City banks have 52 reserve periods a year. Country banks have 26.

2Average amount borrowed for periods in which borrowings were outstanding as percent of required reserves as of similar dates for all borrowers.

Reserves or other liquid assets to cover their liquidity needs. Others presumably either do not have large short-run differences in loan and deposit flows or cover them other ways.

Seasonal credit needs above what can be met reasonably from a bank's own resources provide an acceptable basis for borrowing. There is little indication, however, that many banks have applied for Federal Reserve loans to cover seasonal requirements, even though the liquidity maintained for that purpose may have severely limited their ability to accommodate other credit needs. There is also the possibility that adequate arrangements may not have been made for channeling funds to areas served largely by small banks—areas where demand for short-term credit may increase faster than deposits.

Recognition of these problems has resulted in efforts to determine whether Federal Reserve lending could be used more to relieve pressures on individual banks caused by purely seasonal movements in deposits and loans. The pressure from seasonal movements is felt especially in areas remote from the central money market.

Some banks may have been discouraged from borrowing by a lack of the assets normally used as collateral. For many years, most loans to member banks have been secured by U. S. government securities. But as loans have increased and more and more
funds have been shifted into investments with higher yields, holdings of governments have declined. Some banks have few government securities left, except those pledged against deposits of local, state, and federal governments.

The law specifies the types of short-term customer notes eligible for discount or use as collateral for advances from the Federal Reserve. Such paper was used almost exclusively in the early days of the Federal Reserve System, but it is less convenient for member banks than government securities. The law provides that any sound asset can be used as collateral, but a higher rate has to be charged on borrowings secured by paper that does not qualify for discount. Efforts to amend the Federal Reserve Act by liberalizing collateral requirements have not been successful.

The number of banks with outstanding borrowings from the Federal Reserve varies over the year. Since the beginning of 1966, no more than half the reserve city banks have borrowed in any one-week reserve period, and for a few weeks in 1967 none of them borrowed. The proportion of banks borrowing on a monthly basis has ranged from less than a tenth to nearly three-fourths, with the largest number of such banks using the discount window when credit was tight.

The proportion of country banks borrowing varies much less. Since the beginning of 1967, no more than 9 percent of the district’s country banks have borrowed in any two-week reserve period. The maximum in any month was 12 percent in August 1966. More borrowed in June 1968 than in any other month since then.

The extent of borrowing

For purposes of this article, the amount of borrowing was computed on the basis of daily...
averages for reserve periods—one week for large city banks and two weeks for country banks. From the standpoint of a bank's reserve position, it makes no difference whether the bank borrows $70 million for one day or $10 million for seven days. For the past two and a half years, borrowing by all banks in the Seventh Federal Reserve District has averaged about 20 percent of the national total (member banks of the district normally account for about 15 percent of the total reserves of all member banks). This ratio has varied in the short run, however, especially for large city banks.

Although the district has relatively few large city banks, they usually account for a large part of the total amount borrowed, the exception being when the total is very small. Large banks tend to have wide swings in credit needs. It is not unusual for a single large bank to borrow more in a day or week than all other banks in the district combined. There are also sharp week-to-week variations in the amount of borrowing, largely because of changes in the needs of a few large banks.

On the average, however, the amount of Federal Reserve credit, as well as the number of users, shows a pattern that is clearly related to the availability of funds relative to the demand for credit. After dropping to very small amounts throughout most of 1967, borrowings in the last few months have been roughly comparable to the levels reached during the 1966 period of severe credit restraint.

The cyclical swings in the volume of borrowing reflect both generally heavier demand for credit and changes in rate relationships. When interest rates are rising, the discount rate tends to lag market yields, making Federal Reserve credit more attractive as a source of short-term funds for the adjustment of reserve positions than the purchase of federal funds or sale of Treasury bills. Since big banks, unlike most small ones, normally have access to a number of alternative channels for acquiring funds, their borrowing is more sensitive to changes in rate spreads.

The increase in Federal Reserve lending in 1966 reflected generally larger borrowings as well as a larger number of borrowers. There is no prescribed limit on the amount of credit an individual bank can obtain through the discount window. Under unusual circumstances, banks have been accommodated for short periods in amounts that exceeded their required reserves. Average borrowings are usually well below the average reserves required, however.

In 1967, the ratio of borrowings to re-
quired reserves of the reserve city banks that borrowed, and for the periods they borrowed, ranged from 1 to 35 percent. For almost two-thirds of those banks, borrowings were less than 10 percent of required reserves.

For country banks that borrowed, borrowings were larger relative to required reserves than for city banks. In some cases, the ratio of borrowings to required reserves averaged more than 50 percent. About a third of these banks borrowed less than 10 percent of reserves, on the average.

Although the same banks tend to use the discount window year after year, there are differences in both the frequency and duration of their borrowings. The average borrower bank was in debt to the Federal Reserve more often in 1966 than in 1967. The frequency of borrowings declined most for reserve city banks. More than 40 percent of the reserve city banks borrowed in more than 20 of the 52 weekly periods in 1966, but none used the window that often in 1967.

On the other hand, the average country bank borrower borrowed in almost as many periods in 1967 as in 1966. Moreover, most of these periods were in a single span of consecutive reserve periods, although the amounts borrowed usually varied within the spans as needs changed or portfolio adjustments were gradually accomplished.

To some extent, differences in the patterns of use of Federal Reserve credit reflect geographic differences in credit needs that can often be traced to special problems affecting economic activity in the area. For small banks in agricultural areas, for example, the amount and duration of loans from the reserve bank are more closely related to weather and crop conditions, commodity prices, and seasonal loan patterns than to changes in general credit conditions. While the window may give individual banks temporary relief from credit restraint, this very feature constitutes a "safety valve" that allows more vigorous controls over aggregate credit growth than would otherwise be possible without serious effects on individual banks and areas.

Corporate liquidity—a new low

The liquidity of U. S. manufacturing corporations has been declining since the Korean War. Last year, it dropped to the lowest level in more than two decades.

There are indications, however, that manufacturers' liquidity may not decline further. For one thing, managers seem to have become concerned about liquidity levels. For another, pressures on liquidity seem to have eased.

The conventional ratio

The conventional liquidity ratio for manufacturing companies—measured as liquid assets (cash, bank deposits, and government securities) in proportion to current liabilities—declined from an unusually high 85 percent in 1947-48 to a fairly low 30 percent in 1966-67.

The decline was caused primarily by an increase in current liabilities without a corresponding rise in liquid assets. Since 1950, liquid assets of manufacturing corporations have ranged between $24 and $31 billion, but without any persistent trend. Meanwhile, with
continued growth in their business, manufacturing companies have seen their current liabilities increase substantially. Obviously, these companies have been able to meet a rising flow of bills payable without continually increasing their liquid assets.

The ability to make do with fewer liquid assets relative to the volume of manufacturing activity is shown in the ratio of cash and governments to sales since 1957. Manufacturers' sales more than doubled—rising from an annual rate of $250 billion in the first quarter of 1957 to $607 billion in the fourth quarter of 1967. With liquid assets remaining fairly stable, cash and governments declined as a proportion of sales by about half.

Several developments have influenced managers to make more intensive use of liquid assets. One has been the rise in interest rates since the 1950s—a rise that has given corporate treasurers further incentive to hold cash to the minimum needed to meet current bills. Another has been the broader use of sophisticated management techniques allowing rapid assembly of information on cash positions and better projections of both cash inflows and bills payable. Still another has been the increasing willingness of managers to accept the risks of lower levels of liquidity. This willingness may have been in response to the sustained rise in business activity since the late 1950s, interrupted by only one mild recession.

**Postwar patterns**

World War II ended with manufacturers in very liquid positions. With $22 billion in liquid assets at the end of 1945, manufacturers began converting to the production of goods for long suppressed civilian markets. In less than two years, outlays for inventory, plant, and equipment reduced the liquid assets of manufacturers to less than $18 billion. But with the moderate slowdown in business activity in 1948, liquid assets rose to a new high, reaching an aggregate close to $27 billion. Manufacturers maintained this level throughout the Korean War and the recession of 1953-54.

Manufacturers' holdings of liquid assets have usually risen early in periods of economic expansion and declined before recessions. Liquid assets reached peaks in 1955, 1959, and 1965 and troughs in 1958, 1961,
and 1967. While 1967 was not a recession year, it was a year of only slight growth in economic activity.

These broad cyclical swings in liquid assets can be related to shifts in manufacturers' sales and inventories. When orders increase after a period of sluggish activity, they are filled largely from existing inventories. Corporate liquidity increases as inventories are converted to cash. But as orders continue to increase and inventories decline relative to sales, manufacturers become more optimistic and increase production, both to meet demand and replenish inventories. And as orders increase further, investment in materials, components, and finished goods rise, as do accounts receivable. The rise in these outlays is financed in part from the increase in internal cash flows and in part from the drawing down of liquid assets. Later, outlays are financed with short-term bank loans. Consequently, liquid assets tend to decline late in periods of general economic expansion, even though sales may be reaching new highs.

**Shifts in composition**

The two major components of liquid assets tended to rise and fall together until 1961, although government securities fluctuated more than cash and deposits and clearly dominated fluctuations in total liquid assets. But beginning that year, governments declined in relative importance, with manufacturers holding more and more liquid assets in the form of cash and deposits. Between the end of 1963 and the end of 1967, cash and deposits increased 44 percent while security holdings declined 43 percent.

All nonfinancial corporations, including communications, transportation, and utility companies, as well as manufacturers, have been substituting cash, and especially deposits, for government securities. Since 1961, time deposits have apparently grown faster than any other form of liquid asset. Only recently has open-market paper become important. Checking account balances and holdings of currency have varied, showing no persistent trend.

The shift in the composition of liquid assets was apparently made in response to the availability of certificates of deposit and commercial paper at attractive yields and to the development of secondary markets that provided both instruments with acceptable degrees of liquidity. Since their inception, certificates of deposit
have had higher yields than three-month Treasury bills, which were formerly the prime short-term investment instrument for corporations. The recent growth in the amount of commercial paper held by corporations partly reflects the greater availability of paper issued by corporations with high credit ratings and partly reflects the attractive yields on such paper.

The 1967 bond market

As their liquidity slipped to a low level last year, corporations turned increasingly to new bond issues as a means of raising cash. They had borrowed heavily from banks in the previous year and were concerned that bank credit might be less available in the months ahead—months in which outlays for new plant and equipment were scheduled to continue, though not at the rising rate of recent years. Consequently, an increasing number of corporations required long-term financing.

Manufacturers added $10 billion to their long-term debt last year by issuing bonds. This was roughly a 40-percent increase over their net acquisition of funds from this source in 1966.

The extent of long-term borrowing shows up in the aggregate balance sheet for manufacturers. Bond financing as a percentage of total liabilities and capital rose from 10.6 in 1964 to 12.1 in 1967. Bank loans (short and long-term) also rose sharply as a percentage of liabilities and capital. One result of the increase in both short-term and long-term debt was a higher debt-to-equity ratio for all manufacturers. This ratio rose from 57 percent in 1964 to 70 percent in 1967.

Recent developments

Although the liquidity of manufacturing corporations reached a new low last year, the rate of decline slowed and may possibly have come to an end, at least temporarily, suggesting either that company managers would not or could not allow further declines in their liquidity positions or that the pressures causing the decline had eased.

The decline also slowed for other nonfinancial corporations. In the first quarter of this year, the liquidity ratio for all nonfinancial corporations was higher than the average for last year. Also in contrast with previous years, the ratio for the first quarter was about the same as the ratio for the same quarter a year ago. Until 1967, the liquidity ratio of
nonfinancial corporations was lower in the first quarter of each year than it was the year before.

The improvement in the liquidity ratio for manufacturing corporations this year reflects a better meshing of corporate tax accruals with corporate tax payments. Last year, especially in the first and second quarters, tax payments exceeded the accounting provisions corporations had made for tax liabilities. The underestimate, caused mostly by accelerated tax payments, resulted in a heavy drain on liquid assets. But in the first quarter of this year, accruals exceeded tax payments—possibly because an increase in taxes was expected to be imposed retroactive to January 1. The accumulation of liquid assets associated with these larger accruals may enable corporations to pay tax liabilities without resorting to unusual amounts of bank borrowings.

An easing of the pressure on liquidity positions may also be indicated by the smaller volume of new bond issues in the first quarter of this year. Nonfinancial corporations raised only $2.7 billion from bonds in the first quarter, compared with $4.5 billion in the third quarter last year and $3.8 billion in the fourth. The smaller volume of new long-term debt issues by these companies partly reflects the exceptionally large placements in 1967, following the tight credit situation in 1966 and in anticipation of tight credit and high interest rates again in 1968. It may also reflect the mild improvement in corporate liquidity and the moderate slowing of investment in plant and equipment.

**Summing up**

Much of the long decline in corporate liquidity after the 1940s reflected a shift from high war-induced levels to more “normal” levels. Adding to the persistence of the decline has been the increased efficiency of corporations in the use of their liquid assets, better forecasting of sales, production, and cash disbursements, and the rise in interest rates.

In the last few years, however, with nonfinancial corporations raising more funds from bonds than from bank borrowings, the maturity of corporate debt has been lengthened and the growth of short-term debt has slowed. A slight increase in liquid assets last year and a slowing in the growth of short-term liabilities reduced the rate of decline in the conventional measure of corporate liquidity.
The international monetary system

Further evolution with a diminishing role for gold

The international monetary system has recently been under heavy strain. Large speculative shifts of funds between currencies—and between currencies and gold—have threatened the continued smooth functioning of the international payments mechanism and, consequently, the continued steady flow of goods and productive capital between countries.

The movement of funds was motivated in some instances by the genuine concern of individuals, companies, and at times governments over the future official value of certain currencies. In some instances, it reflected renewed speculation that the price of gold would be raised, allowing speculators quick profits. More fundamentally, however, the movements were symptomatic of weaknesses that have plagued the international monetary system for years.

Joint action by the monetary authorities of several countries has averted the immediate danger to the system. But much more must be done before the system can be considered secure from cyclical or speculative pressures.

The system and its ills

Most transactions in international trade are initiated by private interests, individual and corporate. The important difference from domestic commerce is that payments in international trade are made in currencies that typically must be exchanged into other currencies. If, for example, an Italian exporter of refrigerators is paid in French francs, he must exchange the francs for Italian lira to pay the costs of manufacturing the refrigerators in Italy.

Exchange of one currency into another—and hence the international exchange of goods—is facilitated by conventions that are the foundation of the current international monetary system. Under the system established at the Bretton Woods Conference in 1944, monetary authorities of member countries of the International Monetary Fund maintain fixed rates at which their currencies exchange for the dollar and U.S. authorities maintain a fixed relationship between the dollar and the price of gold, the United States committing itself to buy gold from foreign monetary authorities, and to sell it to them at a fixed price of $35 an ounce.

Authorities maintain the exchange rates of their currencies in two kinds of day-to-day operations.

1. By absorbing any price depressing excesses of dollars developing in the commercial market when residents’ receipts from the export of goods, services, and capital shares exceed their payment to foreigners for imports of goods, services, and capital shares—that is, when the country has a surplus in its balance of payments:

2. By supplying dollars to the commercial market when shortages of dollars develop from excesses of payments over receipts—when the country has a deficit in its balance of payments.

Such operations require that monetary authorities hold reserves in gold or key cur-
rencies. The larger a country's reserves relative to the volume of its international transactions, the greater its ability to finance a deficit in its international balance of payments. Thus, countries like to see their assets in international money grow with their incomes and the volume of their international transactions.

At first—shortage of reserves . . .

Traditionally, reserves have consisted of gold and currencies that were widely accepted in international transactions. The British pound served many years as a reserve currency—and still does for many countries. But with the growing importance of the United States in international trade and finance, the dollar gradually supplanted the pound as the world's major reserve currency.

Many countries were critically short of reserves after World War II. Their treasuries depleted by war and their economies unable to produce enough goods to meet even basic consumer needs, the authorities of those countries were able to maintain the fixed exchange rates for their currencies only by imposing strict controls of purchases and investments abroad. Recognizing the problem, the United States, in the late 1940s, embarked on a broad program of foreign aid that not only helped many countries rebuild their devastated economies but also helped them replenish their reserves.

. . . then a "dollar glut"

The surpluses in the balances of payments of other countries that helped them improve their liquidity positions have had counterparts in the deficits the United States has been running in its balance of payments since 1950. Hardly anyone worried about the U. S. deficit in the early 1950s, but by the late 1950s the attitude of many foreigners toward the United States balance of payments deficit was changing. With their economies booming and their treasuries replenished by gold and dollars, many countries, especially in West Europe, began to view the continuing U. S. deficit with concern.

Part of the concern was due to changes in the deficit itself. As the outflow of U. S. aid dollars was replaced largely by a flow of U. S. private investment abroad, some countries began worrying about the growing dominance of American business in their economies. A larger part of their concern, however, was due to the impact of the continued deficit on
the position of the dollar as a viable reserve currency. The deficit was financed throughout the 1950s partly by the United States drawing down its stock of gold and partly by foreigners accumulating short-term claims on the United States.

In 1960, for the first time in recent history, U. S. short-term liabilities to foreigners exceeded the value of the U. S. gold stock. This, in the minds of many, raised questions about the ability and willingness of the United States to continue making good on its pledge to convert foreign-held dollars into gold at $35 an ounce.

...followed by erosion of confidence

In 1960, rumors that the United States might try to ease the burden of its obligations by raising the price of gold resulted in a wave of speculative buying on the London gold market. That wave was turned by the President-elect's reaffirmation that the United States would maintain the price of gold and his announcement of measures aimed at elimination of the balance-of-payments deficit.

But despite intensified efforts to correct the deficit, it continued into the 1960s. Such measures as the interest equalization tax and the voluntary foreign credit restraint program helped reduce the outflow of capital from the United States, but the escalation of the war in Vietnam imposed an additional burden in 1965 in the form of higher military expenditures abroad, stronger inflationary pressures at home, and a surge of imports.

Against this backdrop, the suspicion that the United States would seek some solution to its balance-of-payments problem other than self-restraint in its domestic economy was strengthened by the continued increase in government spending and the delay in enacting the surtax.

Conditions were similar in the United Kingdom. A continued deficit in the balance of payments there—and the apparent inability of authorities to correct it—made sterling increasingly susceptible to recurrent rumors of possible devaluation and led to the progressive reluctance of monetary authorities as well as individuals and businesses to hold sterling balances as reserves.

These developments undermined confidence in the reserve currencies. Private parties abroad and, in some instances, official monetary authorities turned increasingly to gold as a "safe" asset. For the last two years, the demand for gold has outstripped production of new gold, with the result that, to maintain the price of gold at $35 per ounce, the demand had to be met in part from gold stocks held as official reserves.

As the largest holder of gold, the United States has borne the brunt of this demand, primarily because of its commitment to the International Monetary Fund to maintain a
fixed value of the dollar in terms of gold and to provide free convertibility of officially held dollars into gold. But other governments, interested in protecting the current international monetary system, undertook to assist the United States by participating in the gold pool—a group of monetary authorities formed to help stabilize the price of gold in the free market.1

... and finally the crisis

The years of growing uneasiness were culminated in a speculative run against sterling and finally, last November, in the devaluation of British currency.2 The devaluation of the pound was followed by a heavy wave of speculative gold buying in expectation of the devaluation of the dollar and possibly other currencies. The wave reached its crest in March. In the five months since devaluation of the pound, the U. S. gold stock had declined more than $2.2 billion as the United States and its gold pool partners supplied gold to the London market.

Confronted with such heavy outflows, U. S. and European authorities discontinued the gold pool operations, allowing gold in the free market to find its own price level. They announced they would retain the $35 price of gold as the basis of transactions between central banks but that they would no longer purchase new gold for monetary purposes.

These measures which brought an end to the speculative fever last spring, can have far reaching consequences for the evolution of the international payments system. But whether the long-run potential implicit in the measures is realized will depend largely on further developments.

Remedies—short-run and longer term

The most immediate need is to shore up obvious weaknesses that have threatened breakdown of the system. This requires, above all, restoration of confidence in the reserve currencies. Both the British and the U. S. governments have moved to eliminate some of their domestic economic imbalances that undermined world confidence in their currencies. The recently enacted tax increase and the government’s new resolve to restrain spending are key elements in the U. S. program.

Once these efforts begin to show results, further attention can be given to the more fundamental problems confronting the payments system. To function smoothly, the

1The original participants were, in addition to the United States, the United Kingdom, Belgium, Germany, Italy, France, the Netherlands, and Switzerland. Their individual shares both in purchases and sales of gold were determined by an agreement reached in 1961. (For example, the U. S. share was 59 percent.) France terminated its participation in June 1967.

2See Business Conditions, January 1968.
World's liquidity continues to decline relative to volume of trade

C.I.F.: Includes cost, insurance, and freight.
SOURCE: International Monetary Fund.

system must have continuing growth in reserves to accommodate the preferences of different countries and facilitate ever greater movements of trade and capital. With the supply of gold available for official reserves limited by the production of new gold and desires for private hoards, the system relied largely on the supply of reserves generated by the continued balance-of-payments deficits of reserve-currency countries. The inability of reserve-currency countries to control the size of their deficits and the unwillingness of surplus countries to reduce their surpluses when they became undesirable, combined to weaken confidence in the reserve currencies and threaten the stability of the entire system. To prevent repetition of the near-crisis conditions, a new source of liquidity must be found or a smoother adjusting system devised.

Much exploratory work has already been done, and several proposals have been ad-
liquidity. The plan, already approved by Congress and awaiting official approval by other countries belonging to the International Monetary Fund, could add substantially to the stability of the payments mechanism by reducing the multiplicity of reserve assets in use and preventing the destabilizing influence of shifts from one asset to another.

In contrast to the current system, the proposed plan will make the creation of liquidity more directly responsive to world needs, but it may not solve all the problems of the system. The creation of additional liquidity through SDRs will not relieve countries of responsibility for the management of their domestic economies in a way that will avoid prolonged deficits or surpluses in their foreign accounts. Further modifications, and maybe even fundamental changes, may be needed to deal with this problem, which all along has been "the other side" of the liquidity problem. The plan is, nevertheless, a step in the right direction—a step toward a better functioning international monetary system.