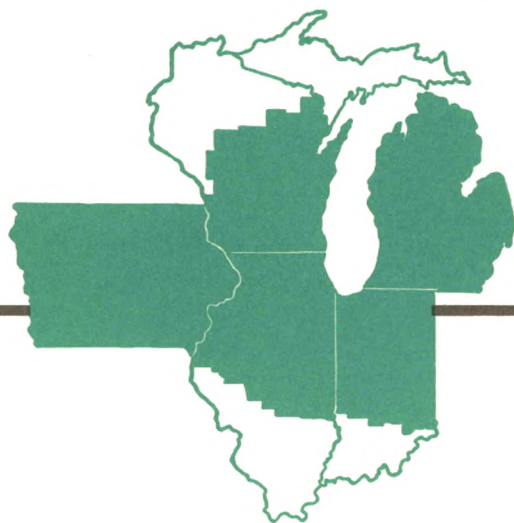


Business Conditions

November 1971



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The coming upsurge in employment

Seventy-one million Americans were employed by nonagricultural establishments in October—600,000 more than at the start of 1971 but a quarter of a million *less* than at the employment peak reached in March 1970. Manufacturing employment, at 18.6 million in October, was no higher than at the start of the year, and 1.6 million less than at the peak set in 1969. In most of the industrial areas of the Midwest, the employment picture in recent months has been less favorable than for the nation.

Following two years of declining activity or subnormal growth, a substantial rise in spending, output, and employment is generally expected for next year. Currently, however, most job markets remain soft with few companies recruiting actively on a largescale. Some companies continue to retrench, and layoffs are still occurring, particularly among manufacturers of machinery and equipment.

2 In some industries that have increased pro-

duction, increases in output per man-hour (productivity) and longer workweeks have reduced the need for additional workers.

No sustained uptrend in payroll employment has occurred in the two years since a cyclical peak in general business activity was reached late in 1969. In the five-year period, 1965-69, employment rose at the very rapid pace of 3.8 percent annually. Even in 1967, a year of retarded growth in general activity, employment averaged 3 percent more than in 1966. In most industrial areas of the Midwest, employment has remained below the 1969 level, reflecting cutbacks in locally important producer equipment industries.

While wage and salary employment has been sluggish in 1971, the labor force has continued to grow, although at a somewhat slower pace than in past years. Despite slight declines in September and October in national totals, unemployment is substantially higher than it was two years ago in almost all

major labor markets. In addition, average workweeks are below the levels of the late 1960s. Finally, many workers released by employers, and many new entrants to the labor force, now hold jobs that do not fully utilize their experience and education.

This article describes recent developments in employment and unemployment, with special reference to the Midwest. It explores the major causes of the current condition, and looks ahead to the substantial growth in employment that appears probable.

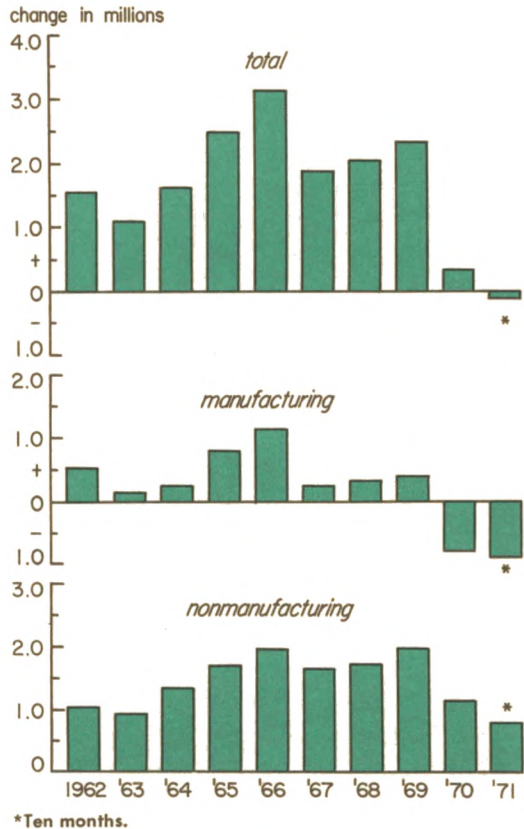
The growing labor force

Total employment was estimated at more than 82 million in October 1971. This total includes, in addition to the 71 million nonfarm wage and salary workers, more than 5 million self-employed and unpaid family workers, about 3.4 million agricultural workers, and 2.7 million members of the armed services. The unemployed—those without jobs, but available for work and seeking jobs—numbered about 5 million in October.

The total labor force, including the armed services and the unemployed, was 87.5 million in October. This number increased by 2.5 million in two years. Growth in the labor force was faster in the late Sixties. From 1966 through 1969, the increase averaged 1.8 million annually.

Individuals are counted as part of the labor force either if they have jobs or are actively seeking work. Each year this number is augmented, at least potentially, by growth in the number of people of working age—defined as those 16 through 65. Of course, many of the people in the 16-25 age bracket, choosing to devote full time to their education, are not in the labor force. Others, in all age groups, are too ill to work, or are confined in institutions. Many women devote full time to their families. People approaching 65

The recent decline in nonfarm payroll employment followed several years of large gains



may take early retirement, an option increasingly more available. On the other hand, millions of people continue to work past 65.

Many millions of potential workers—especially students, housewives, and retired people—are not continuously in the labor market, but take jobs or seek work periodically, depending on individual circumstances and the availability of suitable job opportunities. In times of vigorous expansion, increases in employment may reflect new en-

trants, or reentrants, to the labor force more than reductions in unemployment. In times of declining activity, workers who lose jobs through layoffs do not necessarily remain in the labor force as unemployed people seeking work. In some cases, they “drop out” of the labor force, assuming—rightly or wrongly—that a job search is not worthwhile.

About 61 percent of the noninstitutionalized population 16 years and over are now in the labor force. This proportion rose slightly each year from 1964—when it was 59.6 percent—through 1970. The string of increases may have been broken in 1971. In the third quarter, the labor force participation rate was slightly less than a year earlier—probably because of slack demand.

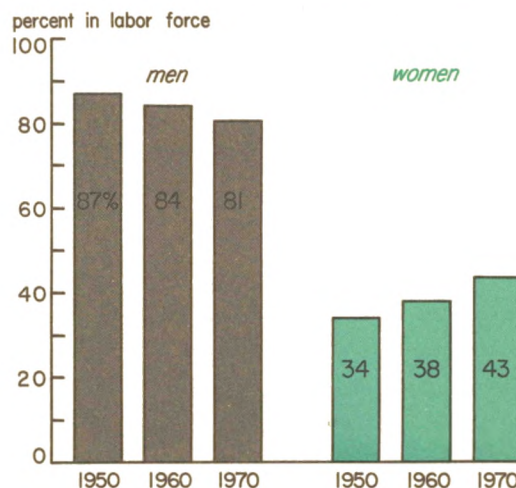
The trend of labor force participation has differed markedly for men and women since World War II. For men, the rate has declined from 87 percent in 1950 to less than 81 percent now. For women, the participation rate increased fairly steadily in this period—from 34 percent in 1950 to 43 percent now.

Various factors have produced diverse trends in labor force participation rates for men and women. Longer years of schooling and earlier retirements have tended to reduce labor force participation rates for both men and women, but these trends have been more important in the case of men. Offsetting developments have brought additional numbers of women into the labor force. Labor saving appliances, and fuller processing of foods, have reduced the time women must spend at household tasks, allowing them more freedom to take full- or part-time jobs. The stigma once attached by some people to women, especially married women, working for pay has gradually eroded. Changes in the age mix of the population, and the long business expansion of the 1960s, also have influenced participation rates for men and women.

About 97 percent of American men, aged 25 to 45, currently are in the labor force. This proportion has not changed significantly since World War II. For men 45 to 55, the rate is 94 percent, down slightly in the past 15 years. Clearly, virtually all of the able-bodied men 25 to 55 are either working or seeking work. Men in these age groups are in their prime working years, usually have completed their formal education, and, typically, support dependents.

The maximum labor force participation for women is in the 20 to 25 year old bracket, at 58 percent. The rate drops to 45 percent in the 25 to 35 bracket, and then rises again in following years, reflecting the easing of family responsibilities as children grow older. In each of the age brackets, however, the proportion of women in the labor force has increased steadily in the past 20 years. This is true even for those women

An increase in the proportion of women in the labor force has offset a gradual decline for men



with children of preschool age. This trend is likely to continue.

Commentaries on trends in unemployment often emphasize the situation for married men (now somewhat less than half of the total labor force) who normally support dependents. As a group, married men obviously are more strongly attached to the labor force than other groups. But needless to say, a large share of the women and single men in the labor force also must work to provide necessities and comforts for themselves and others. Even in cases where workers merely supplement the income of the "bread winner," they contribute to the nation's supply of goods and services, and comprise a vital portion of the nation's labor resources.

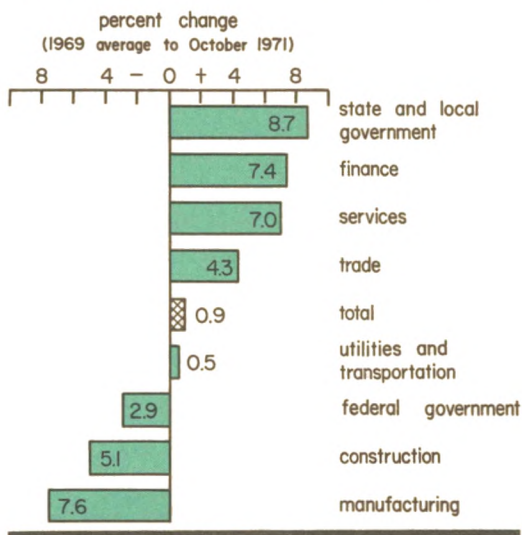
Employment by sector

During the past two years of widespread economic adjustment, changes in employment have varied substantially among industries, and among regional labor markets. For the most part, differences in regional trends in employment reflect developments in the industries that are most important in the area.

The last year of relatively "full employment" was 1969. The following comparisons relate employment in major industries in October 1971, seasonally adjusted, to the annual average for 1969.

In October, state and local government employment showed the largest gain of any sector, up almost 9 percent from the 1969 average. These governments now employ more than 10 million people. States and municipalities have been under strong pressure to improve and expand their services—including education, public health, welfare, sanitation, and police protection. Recently, the limited availability of funds caused by the economic slowdown, and by voter reluctance to approve bond issues and tax hikes, has

Employment has continued to rise in state and local government and in the service industries



forced curtailment of desired programs. But state and local government employment has continued to rise, although at a slower rate than in past years.

Federal government civilian employment was 2.7 million in September, only about one-fourth as large as state and local government employment. Instead of expanding, federal employment in October was 3 percent less than the 1969 average. Part of the decline since 1969 reflects reductions in the Department of Defense and in aerospace activities. A further decline in total federal employment is under way. In August, the President directed federal departments to reduce employment by 5 percent by mid-1972, as part of his economic stabilization program.

While federal civilian employment has declined moderately in the past two years, the armed forces have been cut sharply. In September 1969, the armed forces numbered

more than 3.5 million—near the Vietnam War high. By October 1971, the number was 2.7 million, after declining for 25 consecutive months. The decline apparently continues, but the great bulk of the planned reduction probably has been accomplished.

Among the stronger private employment sectors are finance (including banking, insurance, and real estate) and services (a wide variety of miscellaneous activities), each up about 7 percent in October from the 1969 average. About 3.8 million people are employed in the financial sectors, and almost 12 million in service activities. Employment in these sectors probably will continue to rise because of increasing demands for the services they render. Opportunities to increase output per man-hour through automation in these industries are limited.

Employment in wholesale and retail trade totaled more than 15 million in October, up 4 percent from the 1969 average. Further increases in employment in the trade sectors are likely because of population growth, despite increased emphasis on self-service in many stores.

Total employment in the transportation and public utility industries combined, now about 4.4 million, has changed little in recent years. Within the category some diverse trends have developed. Transportation companies, especially the airlines, have reduced employment, while the utilities have continued to hire additional workers. A recent step-up in air traffic has caused some airlines to increase hirings again.

Contract construction employment, at 3.3 million in October, was 5 percent lower than the 1969 average. Residential construction has been very strong in 1971, but nonresidential construction has declined. Activity in residential construction is expected to remain near this year's level in 1972, while non-

residential construction is expected to increase somewhat.

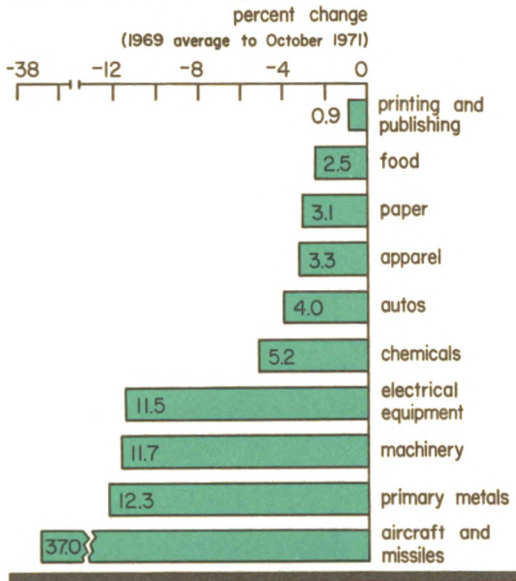
Employment in agriculture (including the self-employed) was less than 3.4 million in September, compared to a 3.6 million average in 1969. Agriculture is the only major sector in which employment has trended downward for many years. Currently, agricultural employment is only half as large as 20 years ago, and only one-third as large as in the 1930s. Innovations in agricultural equipment and techniques over the years have resulted in increases in output per man-hour at a much faster pace than in most non-farm sectors. Because modern technology is not yet applied universally, a substantial further decline in agricultural employment is probable in years to come.

Trends in manufacturing

For all U. S. manufacturing industries, payroll employment totaled 18.6 million in October, seasonally adjusted, down 8 percent from the 1969 average—the largest decline for any major sector. Manufacturing employment apparently is rising again, but no early return to record levels is anticipated. Even assuming a steady rise in manufacturing output, probable increases in output per man-hour and extensions of average workweeks will reduce the need for additional employees.

In recent months, manufacturing employment in most Midwest centers has been further below the 1969 level than has been the case for the United States as a whole. The difference largely reflects lower levels of output in the machinery and equipment industries, and in the primary metal industries—both steel and nonferrous. With less than 16 percent of the nation's population, the states of Illinois, Indiana, Iowa, Michigan, and Wisconsin produce almost one-third of its

Employment in durable goods manufacturing has declined more than employment in nondurable goods



machinery and equipment, and account for about 28 percent of its primary metal industries. According to the Federal Reserve index of industrial production, output of business equipment in October was more than 10 percent below its 1969 average, compared with a decline of less than 5 percent for all industrial production. (In recent months, total output of business equipment has increased slightly.) Primary metal industries were also operating at relatively low levels in October. Steel industry activity was down almost one-third from 1969 as steel buyers reduced strike-hedge inventories accumulated prior to August 1, 1971.

Employment in almost all major categories of manufacturing, both in the nation and in the Midwest, was down from the 1969 average in October, to a greater or lesser

degree. In two relatively stable industries, printing and publishing and food processing, the national decline was less than 2 percent. For paper, apparel, and chemicals, the decline was less than 5 percent. In the more volatile machinery and equipment and primary metal industries, however, employment was down 12 percent in October.

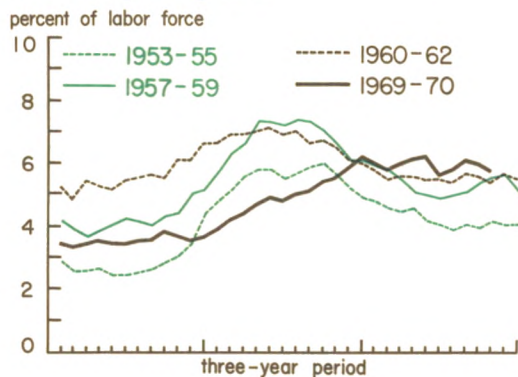
By far the sharpest decline in manufacturing employment since 1969 has occurred in aerospace — both aircraft and missiles. From an 850,000 average in 1969, aerospace employment declined almost 40 percent to less than 500,000 recently. Cutbacks in these industries have played a major role in causing widespread unemployment in some labor markets, especially in the state of Washington, in southern California, and in the Boston area. Aerospace is relatively much less important in the Midwest.

The decline in employment in the machinery and equipment and aerospace industries probably may be giving way to modest increases. But no substantial rise is probable in the near future. A recent survey of plant and equipment spending intentions for 1972 indicates a rise of only 2 percent in physical volume for all industries. Steel output, on the other hand, will rise significantly as inventory reduction programs are completed. Some recalls of laid-off steel workers were announced in October.

A look at unemployment

Unemployment was estimated at just under 5 million for the nation in October, 5.8 percent of the civilian labor force. State estimates for September indicate that the unemployment rates for Illinois, Iowa, and Wisconsin were less than 5 percent. The Indiana rate matched the national average. In Michigan, despite stepped-up auto output (the state's dominant industry) the unem-

The total unemployment rate has remained near the cyclical peak for the past year



ployment rate was almost 8 percent in September. The rates are seasonally adjusted.

The U. S. Department of Labor estimates unemployment each month for many subgroups in the labor force—by age, sex, marital status, race, and previous employment. Recently, special quarterly estimates have been made for Vietnam War veterans and for poverty-stricken sections of major cities. Such detailed data are not estimated for states or metropolitan areas.

In a free economy some “frictional” unemployment always exists, as people “between jobs,” and new entrants to the labor force, seek suitable positions. Unemployment compensation, welfare programs, home ownership, the ability to draw on past savings, and help from friends or relatives reduce pressure on individuals to take jobs that do not suit their inclinations and capabilities. These factors, probably more important than in past decades, tend to raise the level of frictional unemployment.

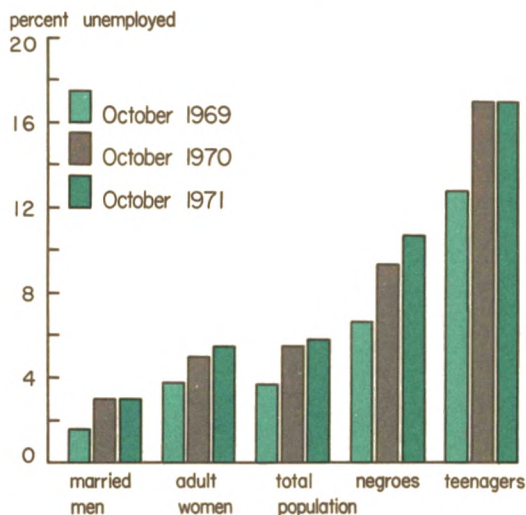
The overall unemployment rate for the

nation has hovered near the 6 percent level since November 1970. In 1969, this rate averaged only 3.5 percent, the lowest level since the Korean War years 1951-53. Overall unemployment rates below 4 percent—some would say 4½ percent—have been associated with large numbers of job vacancies, high labor turnover, inefficiency, and rapid price inflation. These conditions prevailed in 1968 and 1969 in the eyes of many.

Although much higher than in the late 1960s, the current 6 percent unemployment rate is not a record for the postwar period. The rate averaged 6.8 percent in the last half of 1949, 7.5 percent in the worst months of the 1958 recession, and 7.0 percent for a four-month period in 1961. But the duration of the high plateau in unemployment—a full year—is without precedent since the 1930s.

Among the subgroups of the labor force,

The unemployment rate for married men is well below the rates for other groups



the unemployment rate for married men (living with their wives) receives close analysis. The unemployment rate for married men was 3.0 percent in October. This rate averaged only 1.5 percent in 1969. As in the case of the rate for the entire labor force, the unemployment rate for married men in 1969 was the lowest since the Korean War. At no time in the recent business adjustment has the unemployment rate for married men approached the 5.1 percent average rate for 1958, or the 4.6 percent average for 1961.

There are no data on the number of married men, or others, who have lost relatively well-paid jobs, and who have accepted work at lower compensation. Such cases have been especially numerous in the aerospace field, but parallels exist to some degree in many other industries in which managements have been under strong pressure to reduce costs and improve profit margins, even when this has required the release of employees with many years of service. The frequency of such situations in the past year or two probably has not been equaled since the 1930s.

Unemployment rates almost always average lower for men than women, for teenagers than adults, for whites than blacks, and for white-collar workers than blue-collar workers. The relative difference within these groups has not been constant over the years.

For men 20 and over, the October unemployment rate was 4.3 percent, compared to 5.5 percent for women 20 and over. For both sexes aged 16-19, the September unemployment rate was 17 percent. Since late 1970, the teenage unemployment rate has averaged much higher than for any period of similar length since World War II. Teenage unemployment has been boosted in the past decade compared to the 1950s, mainly because of the larger number of young people in the work force, both absolutely and relatively.

How employment estimates are made

The U. S. Department of Labor publishes two separate sets of employment data. The *household series* is based on replies to monthly interviews with individual households. The *establishment series* is based on monthly reports made by employers to state labor departments. Together with information on unemployment compensation, the *household series* and the *establishment series* provide the major sources of statistical information on labor market developments.

Data on the total labor force, total employment and unemployment with breakdowns by age, sex, race, and general categories of employment are derived from the *household series*. The sample used was designed by the Bureau of the Census (Department of Commerce), which collects and tabulates data for the Bureau of Labor Statistics (Department of Labor). It consists of 52,500 households located in 449 areas, some in each state. Trained interviewers contact these households each month to obtain responses to standardized questions. The sample is considered adequate to provide accurate estimates of the characteristics of the U. S. labor force. The sample is *not* suitable for providing information for regions or states.

Data on wage and salary employment, payrolls, average workweeks, and labor turnover by industry (including types of manufacturing) are obtained from the *establishment series*. Reports are furnished by employers to state labor departments, which tabulate the data and forward results to the Bureau of Labor Statistics, which develops national statistics. Comparable data are available for states, metropolitan areas, and for many smaller cities. Many state labor departments also make estimates of total employment and unemployment, using a variety of sources.

Classifications of labor markets by U.S. Department of Labor

| | October 1969 | October 1970 | October 1971 |
|----------------------------------|-----------------|-----------------|-----------------|
| Illinois | | | |
| Chicago | B | C | C |
| Davenport- Rock Island-Moline | C | C | D |
| Peoria | C | C | C |
| Rockford | B | C | D |
| Indiana | | | |
| Evansville | C | C | C |
| Fort Wayne | B | C | C |
| Gary-Hammond | B | C | D |
| Indianapolis | B | C | C |
| South Bend | C | D | C |
| Terre Haute | C | C | C |
| Iowa | | | |
| Cedar Rapids | B | C | C |
| Des Moines | B | C | C |
| Michigan | | | |
| Battle Creek | C | D | D |
| Detroit | C | D | D |
| Flint | B | D | D |
| Grand Rapids | C | D | D |
| Kalamazoo | C | C | D |
| Lansing | B | C | C |
| Muskegon | D | E | E |
| Saginaw | C | D | D |
| Wisconsin | | | |
| Kenosha | C | C | C |
| Madison | B | C | C |
| Milwaukee | B | C | C |
| Racine | C | D | D |

Explanation of labor market classifications

| Class | Description | Unemployment rate |
|-------|--------------------------|-------------------|
| A | Overall labor shortage | Under 1.5 percent |
| B | Low unemployment | 1.5-3.0 |
| C | Moderate unemployment | 3.0-6.0 |
| D | Substantial unemployment | 6.0-9.0 |
| E | Substantial unemployment | 9.0-12.0 |
| F | Substantial unemployment | Over 12.0 |

The unemployment rate for all whites in October was 5.3 percent, compared to 10.7 percent for nonwhites (90 percent of whom are blacks). The unemployment rate for blacks has been about twice the rate for whites for many years.

In designated poverty neighborhoods, unemployment rates are substantially higher than the national average, both for the total and for all subgroups—as might be expected. For Vietnam veterans, 20-29, the unemployment rate was estimated at 8.3 percent in the third quarter, compared to 6.9 percent for nonveteran men in the same age bracket. The differential between veterans and non-veterans was much narrower a year earlier.

Differences in local labor markets

In cooperation with state agencies, the Department of Labor classifies 150 major labor markets each month, assigning letter grades indicating the relative strength of supply and demand for workers. Consideration is given not only to current estimates of unemployment, but also to qualitative judgments of local experts as to the probable persistence of current conditions.

The letter grade A (unemployment less than 1.5 percent) has not been used to classify a labor market since 1957. Grades B and C indicate low to moderate unemployment (under 6 percent), while grades D, E, and F indicate increasing severity of unemployment. These last three groups are designated as areas of “substantial labor surplus.”

In October 1969, only five of 150 major labor markets were in the substantial labor surplus groups. Currently, 65 labor markets are in these groups. Of 24 major labor markets in Illinois, Indiana, Iowa, Michigan, and Wisconsin, only one was in the substantial labor surplus category in September 1969. Currently, 11 are so classified. Two years

ago, 62 of the nation's major labor markets were in the B group (low unemployment, under 3 percent), compared to only six today. None of these are in the Midwest.

Substantial unemployment in major labor markets of the Northeast, Midwest, and Far West is related to conditions in the machinery and equipment, steel, auto, and aerospace industries. The low unemployment centers, of which Washington, D. C., is by far the largest, are all in the South.

Why unemployment persists

In 1968 and 1969, the final years of the nation's longest economic uptrend, many companies were unable to recruit all the qualified workers they needed. A widely-held view in late 1969 was that such conditions would change as the ebullient economy was dampened by restrictive monetary and fiscal policy. Few analysts predicted, however, either the rapidity of the shift from excess demand for workers to underutilization of the labor force, or the extended duration of the changed conditions.

Continued high rates of unemployment, in large part, reflect the fact that total output (real GNP) is only slightly higher than it was two years ago. The long-term growth trend is about 4 percent annually. The fact that manufacturing output is 5 percent below the peak rates of two years ago is reflected in high unemployment rates for industrial centers, particularly those specializing in durable goods.

Other factors have been at work. The growth of imports relative to exports, deci-

sions to close marginal plants (which usually have relatively high labor inputs), gains in output per man-hour, and management decisions to keep new hirings, and training programs, to a minimum until the economic situation is clarified—have all played a role. At present, few private industries or public agencies are expanding their staffs rapidly. Moreover, new layoffs have been announced recently by companies in the industrial equipment, construction machinery, computer, and aluminum industries — all characterized as “growth” industries through much of the decade of the 1960s.

Improvement in 1972

The widely accepted “standard forecast” for the economy for 1972 projects a rise of about 6 percent in total output of goods and services. Following two years of sluggish activity, growth of such magnitude can be expected to be associated with a strong rise in employment and reduced rates of unemployment nationally.

Consumer expenditures have accelerated in recent months, especially for autos and other durable goods. Business firms, however, continue cautious in making capital investments and additions to inventory. Continuance of the improvement in consumer spending can be expected, in time, to encourage increases in business investments. Nevertheless, even economic growth of the magnitude foreseen in the most optimistic projections is not expected to reduce unemployment to the levels prevailing in the late Sixties.

Gold

Part 1: An historical perspective

On August 15, the President of the United States announced suspension of the convertibility of the dollar into gold. With that one action an international arrangement that had been one of the mainstays of the international monetary system for the past quarter century came to an end. The gold exchange international monetary standard—as the arrangement was known—ceased to exist.

Negotiations among the trading nations of the world for new monetary arrangements started almost immediately after the President's announcement. As yet no concrete results have emerged from these negotiations. The foreign exchange markets quickly recovered from the initial shock of August 15, and trading in foreign currencies soon resumed. But arrangements underpinning these operations are viewed by responsible officials as temporary and of a contingency nature at best. Negotiations for more permanent arrangements are continuing. Clearly, more time is needed for negotiators to arrive at an

agreement. Many complex issues, glossed over for several years in the cooperative effort of the participating nations to make the system work, surfaced in the wake of the U. S. action. Resolution of these issues will require extended negotiations and compromises on questions of vital interest to individual sovereign nations.

One of these issues centers on gold, its price and its future role in international monetary arrangements. The controversial nature of this issue stems largely from the peculiar mixture of myths, emotions, and sound economic principles that surround gold. Over the centuries, when gold played an important role both in international monetary arrangements and in the monetary systems of individual countries, this mixture became an integral part of public folklore—and political realities. While sound principles of modern monetary management had long argued for a diminution of the role of gold in monetary arrangements, the widespread

popular mystique of gold has tended to make such a step politically unpalatable. The recent suspension of dollar convertibility set the stage for a fundamental reappraisal of the entire international monetary system, including the role of gold. This article provides an historical perspective on the role of gold in monetary arrangements in the way of background for such a reappraisal. An article to appear in the next issue of **Business Conditions**, will focus on recent developments.

Gold as national money

The world hardly would have progressed beyond primitive stages of economic development if it were not for the emergence of a medium of exchange—money. Money facilitated the specialization of production that transformed countless simple barter societies into an international market economy.

The wide acceptance of gold as a medium of exchange contributed to this process. Because of its durability and scarcity, gold served this function well. Use of gold as money goes back to early recorded history. Some scholars trace the initial use of gold as a medium of exchange to the Egypt of 4300 B.C. As a result of Greek and Roman conquests, the use of gold coins spread throughout Europe by the fourth century B.C. Contrary to popular belief, however, the role of gold in the development of money as a medium of exchange is not rooted in the dawn of civilization. Clay, porpoise teeth, and slave girls—to name only a few commodities—served as money long before gold. And even after gold was adopted as a metal for coinage in ancient times, gold coins remained rather scarce. Silver, because of its relatively greater abundance, was far more widely used. It was only as fresh supplies of gold reached Europe from the

newly discovered American continents in the sixteenth century that gold joined silver as a widely used metal for coinage.

The emergence of gold as a focal point of the monetary system is even more recent. It was only in 1816 that England established the gold sovereign as its primary monetary unit, with silver given only a limited role as legal tender. More than fifty years passed before Germany (in 1871) and the United States (in 1873) followed.¹ Only at the turn of the century did a monetary standard based on gold become prevalent in major countries of the world.

Another popular misconception exists concerning the ability of gold—or of any metallic monetary standard—to assure “proper” monetary management of a country. Evidence shows that as early as the fifteenth and sixteenth centuries, European economies were buffeted alternately by shortages, followed by oversupplies, of the precious metals. In the early fifteenth century, Europe experienced a deep economic depression as a result of an increasingly severe shortage of gold and silver. The situation was somewhat relieved by the discovery of new silver mines

¹On the North American continent, the silver and gold money that circulated in the early period of colonization was brought in by immigrants from England, Spain, France, and the Netherlands. An independent monetary system in the United States was established by the Coinage Act of 1792. The act established the dollar as the basic monetary unit, and defined it as equal to 24¾ grains of pure gold, or to 371¼ grains of pure silver.

The bimetallic standard continued in the United States until Congress passed the Coinage Act of 1873. This act demonetized silver and placed the dollar on the gold standard. Effective convertibility of dollars into gold was not achieved until 1879, however. Initially, the gold value of the dollar was based on the world price of gold—\$19.39 per troy ounce. The price was changed in 1834 to \$20.69 and again in 1837 to \$20.67, where it remained until 1933.

in Germany and Bohemia in 1450. It was not until the New World exploits of the Spanish and Portuguese augmented the “money supply” that the stage was set for the economic and commercial expansion of Europe. But the influx of precious metals soon proved to be economically damaging. The money supply rose too rapidly, and by 1550 Europe found itself in the throes of severe inflation.

Gradual development of bank notes, issued by individual banks and fully convertible into gold, eventually relieved the problem of shortages of supply, but introduced a new element of instability. Economic cycles in many countries tended to be exacerbated by virtually unregulated expansions of money during upswings, and massive contractions (often accompanied by wholesale conversion of paper currencies into gold) during downswings. It was only after individual countries established strong central banking systems charged with the responsibility to regulate the money supply that monetary disturbances of this nature were brought under control.

Gold as international money

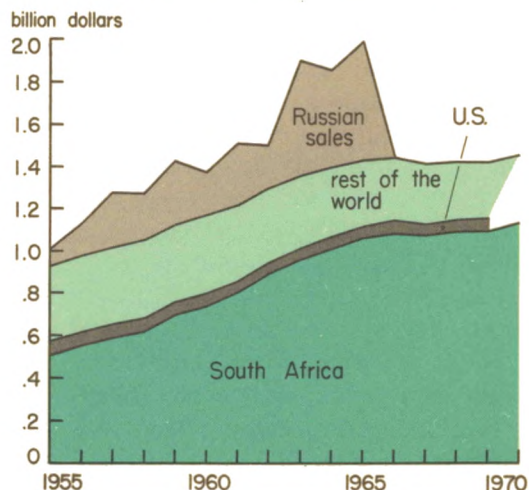
Historically, the international payments system evolved from the domestic payments systems of individual trading countries. As the currencies of all major countries consisted of, or were freely convertible into, gold, international transactions were settled by shipping gold. Besides simplifying international transactions, such shipments were supposed to provide an automatic mechanism for the elimination of deficits and surpluses in a country’s balance of payments.

In a country where individual international transactions undertaken by its nationals involved payments to foreigners in excess of receipts from foreigners—i.e., in a country experiencing a deficit in its balance of pay-

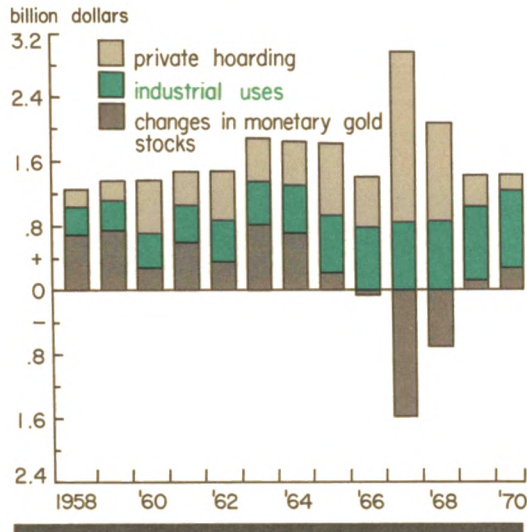
ments—the money supply was reduced automatically as gold flowed out. Scarcity of money in the deficit country was supposed to lead to a reduction in economic activity and to a fall in prices, making the country’s goods cheaper to foreigners. This, in turn, was expected to stimulate foreign demand for the country’s goods and help eliminate the country’s balance-of-payments deficit. A set of forces tending in the opposite direction would be at work in a surplus country: inflows of gold would increase the money supply, push up prices, and thus inhibit exports. This was supposed to reduce the country’s balance-of-payments surpluses.

Unfortunately, however, the international gold standard never really functioned as was intended. The price structure in many countries—particularly in those with advancing industrialization and unionization—was too rigid to respond smoothly to changes in the money supply. Reductions in the money supply due to the outflow of gold did not always lead to export-stimulating reductions in price

Free world’s production of gold...



... is largely absorbed by industrial uses and private hoarding



levels. Rather than cutting prices, producers cut back production and employment. Prolonged balance-of-payments deficits led to rising unemployment.

The impact of gold movements on the economic conditions in individual countries became a great concern to governments, increasingly committed to maintaining the social and economic welfare of their people. It ultimately led to the demise of the gold standard during the worldwide depression in the early Thirties, but only after the governments' prolonged adherence to the "rules" of the gold standard had extracted its toll in terms of spreading unemployment and human misery. Large speculative flows of gold—combined with large-scale conversion of paper currencies into gold—contributed significantly to the spread of the Depression in the early 1930s. By 1933, some 40 countries had abandoned gold in a desperate effort to

protect themselves from worsening economic depression.²

A few countries clung stubbornly to gold. At the London Monetary Conference in July 1933, France, Switzerland, Belgium, the Netherlands, Italy, and Poland signed a pledge to retain the gold standard, forming the so-called "gold bloc." By 1936, long after the rest of the world embarked upon the road to recovery, even the gold-bloc countries abandoned gold amidst deepening depression, rising unemployment, and the resulting social and political turmoil. With that, the gold standard came to an end.

Having experienced the stifling influence of the gold standard, no country (except the United States in the post-World War II international monetary arrangements) permitted its currency to be convertible into gold again.

Gold — postwar

In the postwar international monetary system, the role of gold was reduced substan-

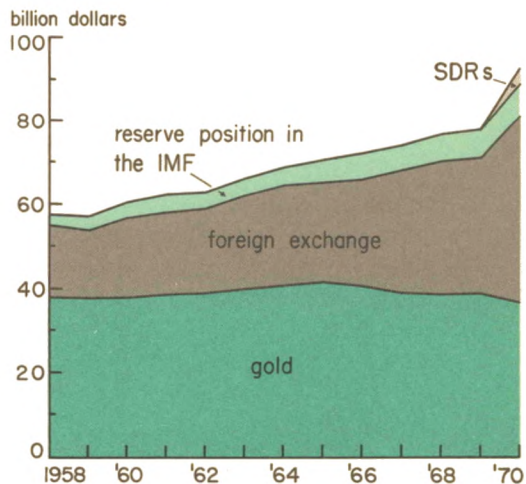
²The United States suspended its commitment to the gold standard in 1933. In January 1934, President Roosevelt, acting under the authority of the Thomas Amendment enacted in Congress in 1933, set the gold content of the dollar at 13.71 grains, increasing the dollar price of a troy ounce of gold to \$35.00. The Gold Reserve Act of 1934 terminated circulation of gold coins and free convertibility of paper currency into gold for U. S. residents. It also prohibited U. S. citizens in the United States from holding gold—a prohibition that in the 1950s was extended to holding gold abroad. The only domestic tie between the dollar and gold that remained—largely as a carry-over from the earlier days—was a requirement that the Federal Reserve maintain gold reserves against its notes and other liabilities. Initially, the requirement set these reserves at 40 percent against notes and 35 percent against other liabilities. In 1945, the reserve requirement was reduced to 25 percent on both notes and liabilities. In 1965, the reserve requirement against liabilities was abolished. In 1968, the 25 percent gold reserve requirement against Federal Reserve notes in circulation was dropped by an act of Congress.

tially. Although the values of the currencies of individual countries were defined in terms of gold, the fixed exchange rates among currencies—the main feature of the postwar system—were no longer maintained by shipments of gold. Instead, monetary authorities in individual countries agreed to maintain a fixed rate of exchange of their currency in terms of the dollar by buying and selling dollars in their respective exchange markets in response to supply and demand conditions. The United States, in turn, undertook to buy and sell gold to and from foreign official institutions at a fixed price of \$35 per ounce. Individual currencies were thus tied to gold only indirectly, through the gold-convertibility of the dollar.

Commitment to intervene in the exchange markets to maintain fixed exchange rates implied that countries must hold reserves. Drawing on these reserves permitted any particular country to offset the temporary imbalance in foreign accounts that occurred when the demand of nationals for foreign currencies to purchase goods abroad created a demand that was greater than current earnings on the country's sales of goods abroad. Without sufficient reserves, the governments had to impose restrictions on foreign purchases to equate the supply and demand of foreign currencies.

Given the shortage of supply of gold, and given the role of the dollar as the "intervention" currency, countries began to hold dollars as part of their official reserves. But even the dollar was in short supply abroad in the years immediately following World War II. To aid reconstruction of war-destroyed economies, the United States embarked upon a massive program of foreign aid. As a result, more dollars flowed abroad than were being received from abroad. Large portions of these were retained by official in-

Importance of gold in world's monetary reserves continues to decline



stitutions abroad as reserves. The resulting growth of reserves made it possible for foreign countries to liberalize trade and foreign exchange policies. This, in turn, fostered growth of international trade and, with it, of the world's prosperity. But in the process of supplying dollars, the United States ran massive balance-of-payments deficits.

Eventually, the consequences of the deficits had to be faced. The U. S. gold stock dwindled as foreign governments exercised their right to convert into gold dollars accruing to them through the deficits. At the same time, claims on the diminishing supply of gold that were held by those governments that chose to retain dollars in liquid form mounted rapidly. Those developments gradually began to undermine the confidence of the world in the U. S. ability to maintain its commitment to convert foreign-held dollars into gold at a fixed price.

Many began to suspect that the United States might substantially increase the price of gold in terms of the dollar in order to increase the dollar value of its gold stock and thus place itself in the position to maintain its commitment. These suspicions began to generate demand for gold by private speculators who hoped to profit by such a move.

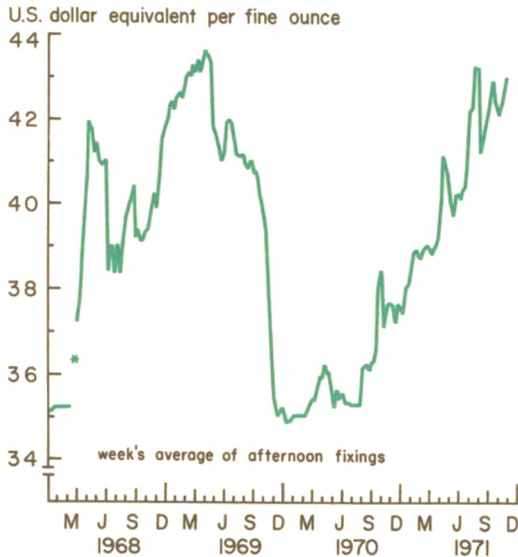
The first such speculative attack came in 1960. The price of gold on the London gold market rose well above the official price of \$35 as speculators bought large quantities of gold in anticipation of an imminent revaluation. To allay the speculative atmos-

phere, monetary authorities entered into arrangements designed to stabilize the price of gold on the free market, thereby demonstrating their determination to maintain a fixed price. The United States, in cooperation with seven major European countries formed a so-called "Gold Pool," which undertook the sale of gold from official reserves to the private market whenever the demand for gold tended to increase the price above the official \$35 per ounce.

The success of this arrangement to stem future disruptive speculation in the gold market was clearly predicated upon the elimination of the fundamental, underlying causes of the speculation—the U. S. balance-of-payments deficit. As long as the deficit would continue to pour increasingly unwanted dollars abroad, the suspicion that the revaluation of gold may take place would persist.

The international monetary system was at an impasse. To accommodate a growing volume of world trade and capital movements, the system needed a growing volume of reserves in the hands of the official institutions charged with maintaining fixed exchange rates to smooth out ever-larger temporary shortfalls of flows of funds. Gold and the dollar had been the primary sources of reserves. But world gold production was insufficient to fill the growing need. The flow of U. S. dollars abroad through U. S. balance-of-payments deficits supplied the needed reserves but at the same time led to confidence-destroying imbalance between the amounts of dollars held abroad and the amount of gold in U. S. reserves that were "backing" these dollars. This, in turn, generated speculation on the revaluation of gold, increasing the private demand for gold, thereby further reducing the supply available to monetary authorities. At the same time, had the United States

After years of officially maintained stability, price of gold fluctuates in response to private supply and demand



*Market supported by Gold Pool up to March 15, 1968 and closed March 15-April 1, 1968.

succeeded in eliminating the source of the instability—the flow of dollars abroad—the world would have had to face the possibility of an inadequate supply of reserves.

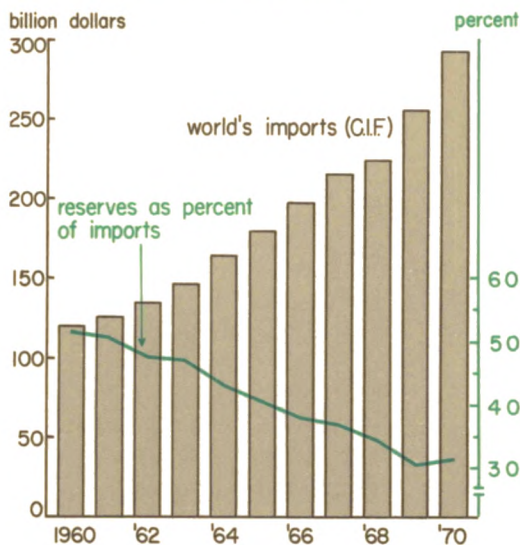
Recognizing the impasse, in the early Sixties, monetary authorities of major countries initiated studies and negotiations aimed at developing an international reserve asset that could be relied on to supplement, and eventually to supplant, the existing assets. This process culminated in 1967 when “Special Drawing Rights” (SDRs) were accepted at the meeting of the International Monetary Fund (IMF) in Rio de Janeiro as an international asset to be issued to individual countries. It was not until 1970, however, that the first issue of the SDRs took their

place in the official reserves of nations.

In the meantime, the gold exchange standard was rapidly approaching its final agonies. In 1966, the private, largely speculative, demand for gold exceeded the world’s gold production of \$1,440 million, and officially-held, international monetary reserves of gold actually declined by \$45 million. In 1967, the decline in the world’s gold reserves amounted to \$1.6 billion. The drain peaked in early 1968, as speculation on revaluation reached a fever pitch. In March of 1968, monetary authorities abandoned efforts to stabilize the private gold market and determined henceforth neither to buy newly-mined gold, nor sell gold to private sources.³ The two-tier gold market emerged as a result. One tier was open to the public, and here the price of gold was permitted to fluctuate daily in response to supply and demand conditions. On the other tier, sales and purchases of the existing stock of monetary gold were limited to monetary authorities of individual countries. On this tier, the authorities agreed to maintain the price of gold at \$35 per ounce.

The establishment of the two-tier gold market and the decision by monetary authorities to stop buying newly-mined gold were important steps in the modern evolution of the role of gold. These arrangements, in effect, drew a sharp line separating two distinct characteristics of gold—one as a useful commodity for industrial use, the other as a monetary metal. A freely fluctuating price in the private market provided an efficient mechanism by which supply and demand could become self-regulating. It provided a framework within which human and capi-

World reserves continue to decline relative to the volume of world trade



18 C.I.F.: Includes cost, insurance, and freight.

³The agreement not to buy gold was later modified to permit purchases of newly-mined gold by the IMF under certain circumstances.

tal resources could be devoted to the laborious process of extracting gold from the depths of the earth in response to the needs of industry—or to the decisions of private holders who wished to hold gold as an asset—as reflected in their willingness to pay the necessary price. On the other hand, the fixed price of gold within the international payments system preserved the role of gold as a point of reference for determining the relative values of individual currencies. At the same time, the decision not to purchase additional newly-mined gold for official monetary purposes formally acknowledged the diminished importance of gold as a source of reserves in the face of the development of the new reserve asset—the SDR—shortly to be put to use.

The March 1968 agreement laid the foundation for a new era in international monetary relations. But before these foundations could be built upon, the problem of the chronic surpluses and deficits in individual countries' international accounts still had to be met. The difficulties involved here were not diminished by the "solution-in-principle" of the monetary reserve-creating problem. Even though, technically, the U. S. deficit no longer needed to be relied upon to provide growth in reserves in the form of dollars flowing abroad (the SDRs were to assume that role), "turning off" the flow of dollars continued to be as difficult as before—if not more so. The inflationary pressures that developed in the U. S. economy in the latter half of the Sixties led to sharp diminution of the U. S. trade surplus—traditionally the strongest point in the U. S. international accounts. In 1969, the U. S. balance-of-payments situation improved briefly as a result of a tight monetary policy instituted for purposes of combating domestic inflation. As U. S. interest rates rose and at-

tracted foreign-held dollars into the United States, the United States recorded a surplus in its balance of payments on the official transaction basis.

But the improvement was short-lived. As monetary conditions in the United States began to ease in late 1970, the flow of funds abroad resumed. In early 1971, the flows were superimposed on the deteriorated U. S. trade position. The combined result was an unprecedented deficit in the U. S. balance of payments and large surpluses in several major European countries and Japan. With the gold issue largely out of the picture, speculators turned their attention to the exchange markets as a possible source of quick profit. Speculation developed that changes in the par values of world currencies would be the means of eliminating the imbalances. By taking a position in currencies to be revalued, speculators stood to make good profit when selling these currencies after their revaluation. The inflow of dollars into official institutions in countries whose currencies were rumored to be likely candidates for revaluation reached staggering dimensions. In recent years, foreign official institutions had refrained from demanding U. S. gold for the "excess" dollars they held in their reserves. But by mid-1971, there was increasing danger that the deluge of dollars into their reserves might force these institutions to cash in large quantities of dollars for U. S. gold. At the end of July, foreign official institutions held almost \$33 billion of liquid claims—against which the United States held \$10.4 billion in gold. A "run on the bank" under these circumstances could have brought the entire monetary system tumbling down in an atmosphere of panic. It was to preclude this eventuality that the President of the United States suspended the gold convertibility of the dollar on August 15.



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