

Business Conditions

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The 1970 amendments to the Bank Holding Company Act: One year later

An expansion of remarks made by Mr. Robert P. Mayo, President of the Federal Reserve Bank of Chicago, to the Chicago Chapter of the Bank Administration Institute on November 16, 1971

On December 31, 1970, following one of the most heated legislative battles in years, the Bank Holding Company Act Amendments of 1970 were signed into law. With only slight exaggeration, the amendments have been called the most important banking legislation since the Federal Reserve Act. For what the amendments did was give concrete expression to congressional concern about the nature of our banking system and its role in the American economy, not only for today and for the next few years, but well down the road into the foreseeable future. Though vague in certain respects, internally inconsistent in others, and not necessarily immutable in its particulars, the policy embodied in the amendments may well influence the character of banking into the next century.

How did such an important piece of legislation come into being? What does it say and, more to the point, what does it mean? What does it portend for banking and the American economy in the 1970s? It may assist bankers and others currently pondering these questions to review the events of

the past several years, putting them in perspective and using them to illuminate subsequent developments.

Rise of the one-bank holding company

Prior to 1967, if the typical banker had been asked what a one-bank holding company was he would have responded with a blank stare. The existence of such an animal had simply never occurred to most people, and even within the small group of bankers, businessmen, and regulators who knew about it, the one-bank holding company was just on the verge of acquiring significance.

As far back as the early 1950s, representatives of the Federal Reserve had argued before congressional committees that the abuses at which regulation of bank holding companies was directed were not dependent on the number of banks owned by the holding company. Nevertheless, the Bank Holding Company Act of 1956 and its 1966 revision limited Federal Reserve regulation to multibank holding companies — companies owning or controlling 25 percent or more of the stock of two or more banks.

The exemption of companies controlling only one bank reflected congressional preoccupation with the possibility that expansion by large multibank holding companies within and across state lines might undermine state laws restricting branch banking and bring about a great increase in the concentration of banking resources.

As late as 1966, when the Bank Holding Company Act was revised, nothing had occurred to make closing the one-bank loophole an urgent matter of public concern. Although one-bank holding companies grew rapidly in number between 1955 and 1965—from 117 to 550—most of them were small, and the fact that they combined banking with nonbanking activities often reflected nothing more than the availability of investment opportunities. Regulating such holding companies promised to be more bother than it was worth.

Beginning in 1968, however, the one-bank holding company movement—by this time it was accurate to describe it as such—took a turn that was sufficiently dramatic to catch the attention of many who, until then, had ignored it. The turning point was the formation by First National City Bank (Citibank) of New York of a holding company to own its own shares. This was the first time that a major money market bank had taken the initiative in forming a one-bank holding company. More significantly, First National City Corporation, as the holding company was named, announced its intention to diversify into a variety of activities prohibited to banks as such.

In large measure, this move reflected an attempt to circumvent legal obstacles encountered when First National City Bank previously had attempted to enter new activities directly. Citibank's attempt to enter the credit card business by acquiring Carte

Blanche ended in a consent judgment in 1968, under which its interest in the credit card company was sold to AVCO, a leading conglomerate. Here the issue was not bank entry into the credit card business per se—many banks were already in the business—but simply that the manner of entry was deemed anticompetitive. Other efforts by Citibank to diversify its activities ran into more direct opposition. Its entry into the mutual fund business through the introduction of the Commingled Managing Agency Account gave rise to lawsuits initiated by the Investment Company Institute and the National Association of Securities Dealers. After losing in the district court and winning in the Court of Appeals, Citibank's Managing Agency Account was defeated in a Supreme Court decision in 1971.

Other banks had been encountering similar barriers to their efforts to diversify. The Association of Data Processors, whose legal standing to challenge a 1964 ruling by the Comptroller of the Currency permitting national banks to offer data processing services had been questioned by the Comptroller, finally won its point in a decision by the Supreme Court in 1971. Still awaiting final disposition is a suit brought by an independent travel agency to block banks from offering general travel agency services.

Long before the judicial system had provided even tentative answers to the issues raised by this litigation, other major banks jumped on the one-bank holding company bandwagon and began to enter nonbanking fields indirectly via the acquisition or establishment of holding company subsidiaries. By December 31, 1968, seven of the ten largest commercial banks in the United States had formed one-bank holding companies. A year later, the list included 43 of the 100 largest banks. Although some bank-

ers continued to watch and wait, it was clear that many believed they had found the key which would unlock what, in their view, were unduly harsh restrictions on the activities of commercial banks. The movement gathered momentum, and by April 1, 1970, one-bank holding companies controlled 1,116 banks and 32.6 percent of the deposits of all commercial banks in the United States.

Reaction and response

It was too much to expect that such a revolutionary transformation of the organization of banking, and of the relationship between banking and other sectors of the economy, would go unchallenged. First to respond, of course, were those most directly affected—the firms in the industries being invaded by subsidiaries of bank holding companies. In addition to the lawsuits sponsored by trade associations, these industries fought back with some of the most intensive and sustained lobbying ever witnessed on Capitol Hill.

But opposition to the holding companies had a much broader base than simply the protection of vested economic interests. Bankers and businessmen to whom memories of the holding company abuses of the 1920s were still vivid, as well as academicians and regulators concerned about the potential implications of unbridled holding company expansion for the safety, efficiency, and competitiveness of the financial system, all expressed reservations about the one-bank holding company phenomenon. The ensuing debate was marked by extremes. A frequently heard prophecy was that arms-length bargaining between borrower and lender would eventually be replaced by the sort of community of financial and industrial interest typified by the Japanese *Zaibatsu*. The death of the free enterprise system was widely predicted, as were the demise of our democratic institu-

tions and their replacement by a quasi-fascist form of state capitalism.

One need not endorse the more extreme of these flights of fancy to acknowledge the grain of truth that they all contain. Indeed, I wish to make plain my strong disagreement with those who believe that the one-bank holding company movement should have been allowed to run its course unchallenged, undebated, and restrained only by the forces of the marketplace. Just as a free society can be maintained only within the framework of the rule of law, the preservation of a free competitive process presupposes some broad restraints on the behavior of market participants. This is an inescapable and well-known paradox, perhaps most familiar to us in the arguments for constitutional government or, more narrowly, in the generally acknowledged need for antitrust legislation. In the case of banking, restrictions on entry, widely regarded as necessary to protect the integrity of the payments mechanism, and the universal need for credit by business give banks an unparalleled potential for influencing the allocation and distribution of resources. It may well be that the maintenance of a competitive financial system that dispenses credit efficiently and without favoritism presupposes the separation of lender and borrower. This implies some limitations on the diversification of banks and bank holding companies into other activities.

But simply to acknowledge the principle that restraints can be, and occasionally are, necessary and desirable, is to say little about their appropriate nature and extent in any given situation. It appears to be as easy, nay easier, for legislatures to err in the direction of overrestrictiveness than in the direction of excessive permissiveness. Given both the great room for legitimate disagreement about the effects of limiting banking diversification

and the magnitude of the private interests at stake, it was inevitable that the battle over one-bank holding company legislation would be long and bitterly contested.

The bills proposed to regulate one-bank holding companies covered the entire spectrum of attitudes toward the industry. Representative Wright Patman's bill, which was strongly supported by representatives of the insurance, travel agency, data processing, and mortgage and investment banking industries, spelled out a narrow "laundry list" of permissible activities for bank holding companies. With few exceptions, these were all activities that banks had traditionally engaged in, or that were extremely limited extensions of their basic loan and deposit function.

The Administration bill favored by the American Bankers Association—once that body had reconciled itself to the necessity of having any new legislation at all—did not mention any specific activities that would be permitted or prohibited to banks. Instead, it spelled out certain broad criteria for determining what would be permissible and assigned responsibility for making this determination to the Comptroller of the Currency, the Federal Reserve System, or the Federal Deposit Insurance Corporation, depending on whether the bank controlled by the holding company was a national, state member, or insured nonmember bank. It was widely believed that this division of enforcement responsibility would favor a liberal interpretation of what was permissible.

For more than two years, Senators and Congressmen had been besieged by representatives of the industries seeking to obtain slightly more favorable treatment than was being accorded others. If one may believe newspaper accounts, by the time the bills came to a vote, most members of the federal legislature were so weary of the issues that

they would have voted for almost any bill just to be rid of the holding company question. After several suspense-filled weeks during which it appeared that the House and Senate conferees might never compromise their wide and strongly felt differences, the Conference Committee reported out the Bank Holding Company Act Amendments of 1970 on December 8. Within the month, the amendments were approved overwhelmingly by both houses of Congress and signed into law by President Nixon.

It is a measure of the genius of the American political system that the legislation finally adopted bore little resemblance to—indeed, was probably superior to—any one of the measures proposed by the contesting parties. The new law was much more than a crude compromise of opposing interests and, with the possible exception of the grandfather clause, reflected next to nothing of the ignoble sentiments that had pervaded the entire debate. With but a few reservations, I believe the legislation to have been sound and in the best long-run interests of the banking system, the economy, and the nation. Although only time will tell, I believe that its basic principles and provisions will endure to have a profound effect on the evolution of the American financial system over at least the next two or three decades.

The new amendments

The 1970 amendments to the Bank Holding Company Act contain many important exceptions, qualifications, and other details, but their essence is rather simply stated. First, they extend the coverage of the act to all bank holding companies, eliminating the one-bank loophole. In contrast to a proposal frequently heard during the hearings on the new legislation, the amended act makes no distinction in its treatment of one-bank and

multibank holding companies. Second, the companies that were recognized as bank holding companies by virtue of the amendments must register with the Federal Reserve, thereby providing some essential data not hitherto available on their number, size, and activities of such holding companies. This step should be completed within the next month or so. Third, and most important of all, Section 4(c)(8) of the amended act lays down a revised set of criteria for determining the permissibility of individual nonbanking activities of bank holding companies. The actual determinations, as under the old act, are left to the Board of Governors of the Federal Reserve System.

The first test that such activities must meet is “to be so closely related to banking or managing or controlling banks as to be a proper incident thereto.” The similarity of this to the wording of the old Section 4(c)(8), is not the result of an oversight. Rather, it reflects the refusal of Congress to adopt any of the proposed alternatives, such as “functionally related to banking.” On the basis of this refusal, it has been argued that Congress intended no change, and certainly no liberalization, in its criteria for determining the permissibility of holding company activities.¹ Such an interpretation would appear to be untenable, in view of Congress’ elimination of the stipulation that the activities of bank holding companies and their subsidiaries “be of a financial, fiduciary, or insurance nature . . .”

In any case, Congress added an entirely new standard to the act, which reads:

In determining whether a particular activ-

ity is a proper incident to banking or managing or controlling banks the Board shall consider whether its performance by an affiliate of a bank holding company can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices.

The position and wording of this sentence suggest that it is simply an elaboration of the meaning of “a proper incident to banking.” In fact, the sentence that precedes it in the act implies that whether an activity is properly incidental depends primarily on whether it is “closely related to banking.”

Actually—as a few minutes’ reflection should make clear—there is no obvious or unvarying relationship between an activity’s closeness to banking and the beneficial or adverse effect on the public of its performance by a holding company affiliate. As a general rule, or example, the competitive effects of acquiring a going concern would be more adverse the closer were the activity in question to banking. Thus, the fact that both banks and mortgage companies make loans for residential construction suggests that mortgage company activities may be considered closely related to banking. But it also enhances the possibility that banks and mortgage companies may be in direct competition, so that their affiliation in a holding company might eliminate existing competition.

In practice, the Board has interpreted Section 4(c)(8) as embodying two distinct tests, both of which must be passed if a given activity is to be approved. Permissible activities must be both closely related to banking and in the public interest when performed by a bank holding company affiliate. Moreover, even though the activity is con-

¹This viewpoint was recently reaffirmed by Chairman Wright Patman of the House Committee on Banking and Currency in a speech before the Arizona Chapter of Robert Morris Associates reprinted in *The American Banker*, November 29, 1971, p. 4.

sidered permissible, each specific proposal to engage in it, whether de novo or by acquisition of a going concern, must pass the public interest test.

The words “closely related to banking” are so vague as to create some extremely difficult problems of interpretation. One basic problem is that the nature of banking itself is constantly changing rather than static. Over the past half century, banking has undergone a fundamental transformation from a wholesale-oriented business, concentrating on short-term lending to business to a department store of financial services with an increasingly retail-oriented approach. Among the services introduced by banks in recent years—not always without opposition—have been data processing services, including payrolls and tax return preparation; management of a commingled investment fund; underwriting revenue bonds; and leasing of personal property. Some of these have been disallowed by the courts; but those that remain represent major changes in what it is that constitutes “banking.” Hence, what is “closely related to banking” may be subject to evolution over time.

But even if the definition of banking were clear and reasonably unchanging, there would still remain some extremely difficult problems in deciding what was closely related to it. There are many different ways in which nonbanking activities can be related to banking. The choice of which way is crucial. Some activities, such as mortgage banking, are closely related to banking in the sense that they provide similar services to an overlapping group of customers. Other activities, such as data processing, may be related technologically, in the sense that computer management of a customer’s checking account may produce much of the information necessary for processing his tax

returns, etc. Some activities, such as armored car and messenger service, may stand in a vertical relationship to banks, in the sense that they constitute a necessary input into the banking business. Or activities may be related to banking in the more remote sense that they utilize a technology similar to that used by banks. The point is simply that there is no universally agreed-on procedure for classifying an activity as closely related to banking. The Board will have to make some more or less arbitrary judgments to give concrete meaning to this part of the act.

In the process of implementing the public interest standard, the Federal Reserve finds itself having to blaze new paths of interpretation and analysis. It is required, in effect, to measure all the costs and benefits of allowing holding company affiliates to perform a given activity, to weigh them in some unspecified manner, and to decide on the basis of the result whether the activity should be permitted. Aside from the need to make a number of important value judgments, the Board is handicapped by the fact that Federal Reserve staff personnel are only gradually becoming familiar with the technology, demand conditions, and state of competition in most fields of activity other than banking. Consequently, implementation of the provisions dealing with nonbanking activities is proceeding slowly and cautiously.

Implementing the amendments

Even before the amendments were enacted, the Board’s staff and those of the 12 Reserve banks were busy in anticipation of the hectic workload that was to follow. Early in 1971, the Board began to consider a list of activities proposed by the Association of Registered Bank Holding Companies. These were all activities that one or more members of the association had expressed some in-

terest in entering and which they believed to satisfy the requirements of the amended Section 4(c)(8). The Board assigned the writing of background papers on each of these activities to research personnel within the System.

On January 25, 1971, the Board proposed amendments to its Regulation Y, listing ten activities as permissible for bank holding companies under the new law. At the same time, it asked for comments and suggestions from interested parties to be received not later than February 26, 1971.

Although the Board is empowered to approve activities either by the promulgation of general regulations or by order in individual cases, it indicated its intention to proceed by regulation at first and to process individual applications under the new Section 4(c)(8) only “in unusual and exigent circumstances.” The purpose of this deferral of applications was obviously to give the Board time to consider some of the broader issues before getting bogged down in a heavy caseload of applications for the acquisition of companies engaged in activities that may not even be among those eventually declared to be permissible.

In March, the Board announced its intention to hold hearings in April and May on the ten activities that it was considering. The first hearing, scheduled for April 14, was devoted to questions having to do with eight of the ten activities proposed as permissible. Hearings on data processing and acting as an insurance agent or broker were scheduled for April 16 and May 12, respectively. As expected, the hearings generated a great deal of heat and at least some light. It is perhaps not too unkind to remark that much of the testimony received was merely a restatement of arguments already familiar to the Board through the official transcripts of Senate and

House Banking committee hearings.

In any case, the Board was persuaded to postpone decisions regarding the permissibility of acting as an insurance agent or broker, acting as an insurer, or providing data processing services. On May 27, it approved the other seven activities, with minor modifications, effective June 15. In doing so, the Board indicated that it was not imposing any general limitation on the location of nonbanking activities, but might impose such limitations by order in individual cases.² It also made clear that the activities of approved holding company subsidiaries were not to “be altered in any significant respect from those considered by the Board.”

On June 15, effective July 1, the Board added an eighth activity to the approved list—data processing services. In approving the activity, the Board imposed fewer restrictions than expected—fewer even than in its original proposal—and thereby produced a great deal of disappointment in the data processing industry. The Board had considered but finally rejected provisions that would have limited data processing for parties other than subsidiaries of the holding company or other financial institutions to some proportion of the holding company’s total data processing business. Aside from the obvious administrative difficulties such a provision would have presented, it was believed that an arbitrary quantitative limitation on the ability of bank holding companies to compete for data processing bus-

²On December 6, Federal Reserve Board Governor George W. Mitchell made known his belief that geographical restrictions on bank holding company activities are “generally hostile to the public interest because they sequester competitive forces instead of releasing them.” If this is representative of the Board’s views, it suggests that geographical limitations will be imposed sparingly and only where an affirmative need for them has been demonstrated.

iness made no sense. If, indeed, it is in the public interest for them to offer such services, they should be encouraged to do so. What the Board did was to specify that the information processed should be "banking, financial, or related economic data . . ."

In general, the Board has not seen its role as rubber-stamping decisions made by other agencies regarding appropriate activities for banks. Thus, the fact that the Comptroller of the Currency had ruled that a national bank might offer a given service would not be taken as conclusive in determining whether the same service would be permissible for bank holding companies. This could lead to a situation in which a Board refusal to authorize an activity for bank holding companies could be nullified by the bank's carrying on the activity directly. A possible deviation from this general policy was the Board's action, effective September 1, adding insurance agency and broker functions to the list of permissible activities. That such activities traditionally had been performed by state banks where permitted by state law and by national banks in communities with populations not exceeding 5,000 probably was not totally ignored by the Board in its decision. This was the ninth of the ten activities originally proposed to be approved by the Board, leaving only "acting as an insurer" to be acted upon. The nine activities that have been approved are:

(1) making or acquiring, for its own account or for the account of others, loans and other extensions of credit (including issuing letters of credit and accepting drafts), such as would be made, for example, by a mortgage, finance, credit card, or factoring company;

(2) operating as an industrial bank, Morris Plan bank, or industrial loan company, in the manner authorized by State law so long as

the institution does not both accept demand deposits and make commercial loans;

(3) servicing loans and other extensions of credit for any person;

(4) performing or carrying on any one or more of the functions or activities that may be performed or carried on by a trust company (including activities of a fiduciary, agency, or custodian nature), in the manner authorized by State law so long as the institution does not both accept demand deposits and make commercial loans;

(5) acting as investment or financial adviser, including (i) serving as the advisory company for a mortgage or a real estate investment trust and (ii) furnishing economic or financial information;

(6) leasing personal property and equipment, or acting as agent, broker, or adviser in leasing of such property, where at the inception of the initial lease the expectation is that the effect of the transaction and reasonably anticipated future transactions with the same lessee as to the same property will be to compensate the lessor for not less than the lessor's full investment in the property;

(7) making equity and debt investments in corporations or projects designed primarily to promote community welfare, such as the economic rehabilitation and development of low-income areas;

(8) (i) providing bookkeeping or data processing services for the internal operations of the holding company and its subsidiaries and (ii) storing and processing other banking, financial, or related economic data, such as performing payroll, accounts receivable or payable, or billing services; and

(9) acting as insurance agent or broker in offices at which the holding company or its subsidiaries are otherwise engaged in business (or in an office adjacent thereto) with respect to the following types of insurance:

(i) Any insurance for the holding company and its subsidiaries;

(ii) Any insurance that (a) is directly related to an extension of credit by a bank

or a bank-related firm of the kind described in this regulation, or (b) is directly related to the provision of other financial services by a bank or such a bank-related firm, or (c) is otherwise sold as a matter of convenience to the purchaser, so long as the premium income from sales within this subdivision (ii) (c) does not constitute a significant portion of the aggregate insurance premium income of the holding company from insurance sold pursuant to this subdivision (ii);

(iii) Any insurance sold in a community that (a) has a population not exceeding 5,000 or (b) the holding company demonstrates has inadequate insurance agency facilities.

Recently, the Board has issued proposals that serving as an investment adviser to mutual funds and performing property management services be added to the list of permissible activities. In October, it received a letter from Richard W. McLaren, Assistant Attorney General in charge of the Antitrust Division, questioning the legality of bank holding companies acting as advisers to mutual funds. Though acknowledging the probable procompetitive consequences of holding company entry into the activity, McLaren suggested that it might constitute a violation of the Glass-Steagall Act separating commercial and investment banking. The Board held hearings on several questions related to factoring and serving as investment adviser to a mutual fund on November 12.

The first applications

A Board press release on May 27 announced that applications to engage in nonbanking activities subject to Section 4(c)(8) were being accepted. Since then the number of such applications has gradually risen, as the principles governing the Board's actions have become clearer. As expected, applica-

tions for de novo entry by bank holding companies into activities already included on the approved list have received liberal treatment. Indeed, most such applications are deemed automatically approved unless objections are raised by the Reserve bank.

In the area of acquisitions, mortgage companies have produced the greatest activity and raised some of the most difficult problems, especially with regard to competitive effects. As of late October, the Board had under consideration seven applications to acquire mortgage companies, many involving extremely large banks and leading mortgage companies in the same city. Because both banks and mortgage companies make real estate loans, there is considerable competitive overlap between the activities of the two types of institutions. Consequently, there is some question whether bank holding companies should be allowed to acquire mortgage companies located within the same local geographic area served by the holding company's bank or banks. Indeed, a speech in April by Donald Baker, acting director of Policy Planning in the Antitrust Division, indicated that the Justice Department would scrutinize such cases very closely and urged holding companies to look to distant markets for nonbanking acquisitions. The Board held hearings on these and other issues in mortgage company cases on November 8.

The hearings on mortgage companies and the actions taken by the Board on the first several applications involving mortgage companies warrant your closest consideration. In addition to setting precedents for subsequent cases, the actions taken by the Board in these cases will serve as a useful indicator of its attitudes toward the competitive and other issues in holding company expansion into nonbanking areas generally. To paraphrase an old quotation usually applied to the Su-

preme Court's interpretation of the Constitution, the Bank Holding Company Act Amendments of 1970 mean what the Board says they mean—at least until new litigation or legislation changes the rules.

The amendments in perspective

Domestic nonbanking activities of bank holding companies have been only one concern of the Board in its task of implementing the Bank Holding Company Act Amendments of 1970. A number of other questions have had to be cleared up before those affected by the amendments could be certain of their status. For example, on September 20, the Board announced the types of foreign business activities that would be permissible for domestic bank holding companies. On the same day, the Board issued a list of rules and presumptions that would guide it in determining when a company exercises control over a bank or other company. These rules were designed to simplify implementation of the provisions in the 1970 amendments that broaden the Board's ability to find control in situations when a company owns less than 25 percent of a bank's stock. Many other minor issues, including a great number of purely procedural questions, have been dealt with along the way since the amendments were enacted at the end of last year.

But the fact remains that the key issue in the implementation of the amendments is the treatment to be accorded holding company plans for expansion into nonbanking areas. Although Congress originally set out to settle just this question—and succeeded, in the sense of specifying the broad criteria that should govern such expansion—the buck has

now passed to the Board of Governors. It is, of course, too early to speculate about the minute details of the Board's ultimate policy. But several principles have already become clear. The Board is on record as being sympathetic to the banks' reasons for wanting to expand their horizons. There is no obvious reason why arbitrary restrictions should limit commercial bank participation—whether directly or via the holding company route—in the great expansion of the financial service industry expected over the next several decades. At the same time, the Board supports the clear mandate of Congress that the separation between banking and commerce be preserved. It is willing to see the wall between the two displaced only to the extent that the holding company form of organization offers some insulation from the possible adverse effects that might accompany the banks' entry into certain activities directly.

Regarding acquisitions of companies in lines of business already included on the approved list, final conclusions must await the Board's action in the first cases under Section 4(c)(8). My own strongly felt belief is that the Board will apply essentially the same strict competitive standards that have marked its decisions on applications to acquire banks under Section 3(a)(3), modified only to the extent necessary to take into account the additional criteria included in the public interest test of Section 4(c)(8). Beyond that, I am unwilling to hazard any guesses, other than to suggest that the next year or so should be every bit as interesting as the last year in the area of bank holding company expansion.

Gold

Part II: Future without glitter

The article “Gold—An historical perspective” in the last issue of **Business Conditions** traced the role of gold in monetary arrangements from its rise to the center of the world’s payments system at the turn of this century through its lingering demise through the Thirties and the postwar period. This article focuses on issues involved in recent negotiations leading to the restructuring of the international monetary system.

Severing the gold link

The suspension of the convertibility of the dollar into gold on August 15, 1971 inactivated the last operational link of world currencies with gold. In a sense, the action of the President of the United States last summer marked the end of an era. But more fundamentally, it merely formalized a situation that existed for years. In the late 1960s, foreign monetary officials largely refrained from demanding gold from the U. S. Treasury in tacit recognition that the U. S. “gold window” would be closed at any time that the United States was confronted with large volumes of foreign-held dollars for conversion into gold. For all practical purposes, the dollar was not “exchangeable” into gold. Yet during this period, the international monetary system performed well its basic function—facilitating flows of goods, services, and productive capital among nations on a scale never before realized. The de

facto absence of a link between the currencies of major trading countries and gold had little influence on the functioning of the system.

The myth of gold—its ability to bestow value on currencies and viability on a monetary system—has long been dead. What made the international monetary system function as long as it did was a cooperative, international effort to make it function. What ultimately made the system break down was the inability or unwillingness of the countries that benefited from the system to render enough cooperation to undertake either the internal or external adjustments that would have eliminated disruptive deficits and surpluses in their balance-of-payments accounts. This reality formed a backdrop in the negotiations for the reform of the system.

Reestablishing fixed exchange rates

The primary responsibility of monetary officials has been to come up with a payments system that will serve the needs of international trade and commerce and be compatible with national desires for domestic full employment, price stability, and economic growth. “Floating” currencies, adopted by major countries following the suspension of the gold convertibility of the dollar, were viewed widely as merely temporary arrangements. While “floating” freed the monetary authorities of individual countries from the

necessity of supporting the exchange rate of their currency relative to the dollar (which used to entail sales and purchases of dollars with domestic currency in domestic markets), it also introduced an element of uncertainty as to the future values of international contracts. This uncertainty was considered by many to be a serious impediment to international commerce.

The consensus among monetary experts throughout the current negotiations had been that a regime of relatively fixed—but somewhat less rigid—exchange rates, similar to the one in existence prior to August 15, should be readopted as the basis for any new system. But it was clear that relative exchange rates must be at new levels.

The exchange rates of many countries were established years ago and were maintained, with few exceptions, despite fundamental changes in the productivity and relative economic developments that had taken place in individual countries. Misalignment of the rates at which currencies exchanged for each other was the underlying cause of the persistent surpluses and deficits in the international accounts of individual countries. And these surpluses and deficits—and the unwillingness or inability of individual countries to eliminate them—were the source of the difficulties in the functioning of the international monetary system in recent years. Internal policies adopted by individual countries in their pursuit of domestic objectives of full employment and economic growth were traditionally either inadequate or, in some instances, in direct conflict with international objectives of eliminating deficits and surpluses. It was clear, therefore, that the elimination of the disruptive imbalances must be achieved through external measures—the realignment of the rates of exchange.

Realigning the rates

Since August 15, when official maintenance of fixed exchange rates stopped, and until mid-December, when agreement was reached by the ten leading trading countries of the noncommunist world, the exchange rates of currencies of major surplus countries “floated” upward relative to the currency of the major deficit country, the United States. In principle, this occurred for the following reasons. Prices (i.e., the exchange rates) of individual currencies in terms of each other were determined in a free, day-to-day market just like the prices of any other commodity—by supply and demand. The supply of any particular currency on the foreign exchange market in any one country was generated as residents disposed of the proceeds of their individual transactions in that particular currency. Demand was generated as the residents attempted to acquire that particular currency to make payments abroad in settlement of their individual transactions. A surplus in a country’s balance of payments meant that in the aggregate the residents of that country were receiving more payments from abroad than they were sending abroad. The supply of foreign currencies in that country exceeded the demand. In the face of excess supply, the price continued to drop until it reached the point where the “cheapness” attracted enough buyers on the demand side to take the available supply off the market. The values of foreign currencies in terms of the U. S. dollar rose on the foreign exchange markets as the market forces generated by the U. S. balance-of-payments deficit and European balance-of-payments surpluses were permitted to exert their influence on the relative value of these currencies.

There were some who suggested that these “market-determined” exchange rates should be adopted as the base for the future

system of fixed exchange rates. But the extent of appreciation and depreciation resulting from this process was distorted by two factors: unusual speculative conditions in the world's exchange markets; and efforts on the part of some countries to limit the market-induced appreciation of their currencies either by the imposition of restrictions on international transactions of their residents or by direct governmental intervention in foreign exchange markets. Because of these, floating exchange rates failed to produce a structure sufficiently changed to eliminate past disequilibria. A more equitable structure had to be determined by negotiations.

The prime task confronting monetary officials of the ten major noncommunist trading countries engaged in international negotiations had been to determine where the exchange values should be pegged once the system reverted to the fixed exchange rates

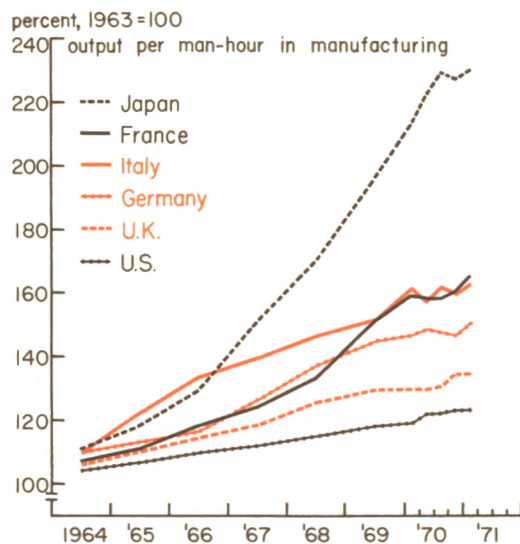
regime. This was a difficult process. The extent of the relative change in the external values of individual currencies directly influences the competitiveness of a nation's products on world markets, its ability to sell its products, and its ability to provide domestic employment. These, clearly, were very sensitive areas of decision for any government. It was no wonder that the negotiations were prolonged.

Achieving the realignment

The controversy over the realignment of currency values was not limited merely to the question of extent of relative revaluation and devaluation. Equally controversial was the question of the means of achieving it. The issue had been: should the surplus countries revalue their currencies relative to the dollar, or should the deficit country (i.e., the United States) devalue the dollar in terms of gold? In purely technical terms of what was expected of the realignment, a uniform 10 percent upward revaluation of surplus countries' currencies relative to the dollar would be approximately equal to a 10 percent devaluation of the dollar relative to gold. This would hold provided that in the latter case the surplus countries in question maintained the gold value of their currencies unchanged, and all other countries, as was generally assumed, maintained the same external value of their currencies relative to the dollar.

Straightforward as this proposition is in economic terms, it generated a great deal of controversy in the negotiations. Some countries preferred that the adjustments be effected, at least in part, through the devaluation of the dollar (i.e., through an increase in the dollar-price of gold). Their argument seems to have been based largely on the proposition that the deficit country, the United States, must bear much of the burden

Productivity abroad increased faster than in the United States



of the adjustment. Initially, there was opposition to this measure largely on the grounds that an official action increasing the dollar-price of gold might tend to perpetuate the myth of the importance of gold in monetary arrangements.

But eventually the United States withdrew its opposition to devaluation as the view became more widespread that unless an early compromise was agreed upon, world commerce would suffer irreparable damage from the continuation of the unsettlements in the exchange markets. On November 13, President Nixon announced that the United States would devalue the dollar as part of the general realignment of currencies.

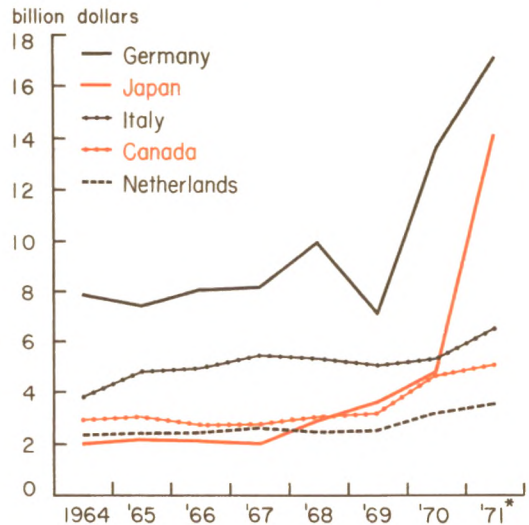
The announced willingness of the United States to devalue the dollar provided a basis for an agreement at the meeting of the finance ministers and central bank governors of Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, the United States, and representatives of the International Monetary Fund (IMF) on December 17 and 18. The exchange value of the major currencies were redefined, and the United States agreed to devalue the dollar in terms of gold by increasing the dollar-price of gold to \$38 per ounce.¹

The meaning of the realignments . . .

The fundamental issue in the current international monetary crisis—and indeed for many years preceding the crisis stage—was

¹The devaluation of the dollar, although already effective in the exchange markets, will become “legal” only after approval of the measure by the U. S. Congress. In a similar vein, many countries declared new “central values” of their currencies in terms of the dollar rather than new “par values.” Central values need not be officially approved by the IMF and are considered temporary, pending final U. S. action.

Foreign reserves soared



Note: Reserves include gold, foreign currencies, reserve position in the IMF, and SDRs.

the misalignment of the relative exchange values of major currencies. Reaching an agreement on this issue overshadows in immediate significance any other issues. The redefinition of the values of individual currencies in terms of gold has been the means toward that end. In itself, redefining values in terms of gold was of little practical significance. Since the cessation of the official convertibility of foreign currencies into gold in the Thirties, and of the dollar on August 15 of this year, the valuation of currencies in terms of gold has been largely an accounting convenience. Gold provided—and continues to provide—a fixed point, a “numeraire,” against which the exchange rates of individual currencies can be defined. Beyond that, because at this time no sales or purchases of monetary gold are undertaken, the redefinition of the value of gold in terms of individual currencies merely changes the book

value of the existing monetary gold. A country that has revalued its currency in terms of gold will have the book value of its official gold stock (as well as its holdings of other foreign currencies that were devalued relative to gold, that held steady, or were revalued less than that particular currency) reduced in terms of its own currency. For the United States as the devaluing country, the dollar value of the U. S. gold stock as well as other foreign assets will increase, and the government will record a "bookkeeping profit" once the devaluation becomes official.² Should the convertibility of the dollar into gold be resumed, and at that time, should any country choose to sell some of its gold to the U. S. Treasury, the new, higher price of gold in terms of the dollar would become economically relevant. The selling country would receive more dollars for a given amount of gold than it would have received prior to the devaluation of the dollar. But until the time the United States, or any other country, is prepared for unlimited official trading in gold, gold will remain an illiquid asset for official holders, somewhat inferior to SDRs, the dollar, or any other convertible foreign currency in official reserves in its immediate usefulness in meeting, on a large scale, the purposes for which official reserves are held.³

²During the 1934 devaluation, most of the resulting "bookkeeping profit" was transferred to the Exchange Stabilization Fund of the U. S. Treasury. The bulk of this amount was later used to finance the U. S. quota subscription in the IMF. The "profits" from the currently pending revaluation will be offset by the automatic rise in certain U. S. dollar liabilities (e.g., currency subscriptions in the IMF).

³According to Article V Section 6 of the Articles of Agreement of the International Monetary Fund, countries may sell gold to the IMF for other foreign currencies. However, the capacity of the IMF, in effect, to underwrite the official gold market is limited. Thus, large-scale purchases of gold by that institution would no doubt require some special agreements among member countries.

The realignment of currencies in terms of gold has not altered the declining significance of gold in the international monetary arrangements. The real, immediate significance of the measures rests in the realignment of the value of the currencies. Here is how the realignment is expected to work. In principle, devaluation of a currency reduces the amount of other currencies that can be bought with a given amount of a currency that is devalued. Revaluation, of course, is the "other side of the coin"; larger amounts of foreign currencies can be purchased with a given amount of a revalued currency.

Neither devaluation nor revaluation, as such, has any direct impact on the domestic internal value or the purchasing power of the home currency. There is only the indirect domestic impact arising from the effect of devaluation or revaluation on prices of imported goods and services; these prices tend to go up in the country that devalues, down in the country that revalues. But it is these indirect impacts that are expected to bring about changes in the flows of trade and capital among countries, and thereby eliminate longstanding disequilibria.

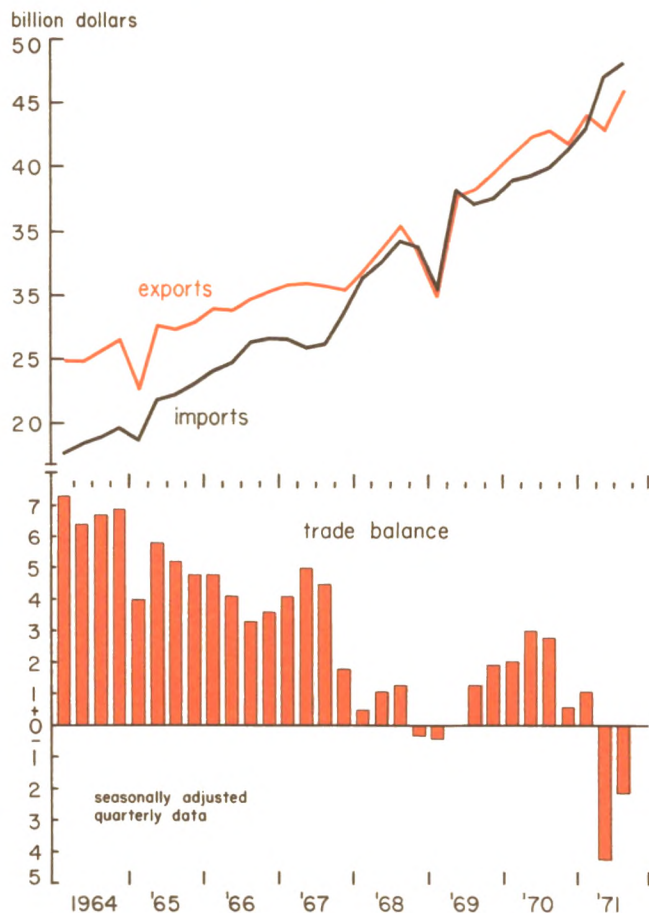
In addition to increasing prices of imported goods, a devaluation reduces the prices of domestically-produced goods and services that are purchased by foreigners. Take, for example, a tractor that costs \$5,000 in the United States. Before the changes in the relative values of the currencies, a prospective Japanese buyer would have needed 1,800,000 yen (i.e., $5,000 \times 360$, given the previous exchange rate of $\$1.00 = 360$ yen) to purchase it. After the dollar was devalued and the yen revalued, the tractor still costs \$5,000 in the United States. But it will now take only about 1,540,000 yen, given the new exchange rate of $\$1.00 = 308$ yen. To the Japanese buyer

using yen, the price of the U. S.-made tractor has been reduced by about 260,000 yen.⁴

Similar reductions, proportional to the extent of the relative revaluation, will confront prospective buyers of U. S. goods in all countries whose currency values have risen relative to the dollar. Such price reductions are expected to stimulate demand for U. S. goods abroad, and lead to increases in U. S. exports. This, in turn, is expected to increase production and employment at home.

What is just as important is that devaluation of the dollar is expected to have the opposite effect on U. S. imports because of its impact on the prices of foreign-made goods purchased by U. S. residents. Let us take as an example a German automobile that costs 7,320 marks in Germany and sold in the United States last year for \$2,000 plus transportation cost from Germany. After the German mark rose in value relative to the dollar, nothing basically changed for Germans as far as the price of the car was concerned, as expressed in terms of German marks. But with the mark revalued, a

Devaluation of the dollar is expected to bolster U. S. foreign trade . . .



prospective U. S. buyer will need \$2,271 plus transportation cost to purchase the car. Since the prices of domestically-produced cars will remain essentially unchanged, they will become more attractive to prospective buyers, and some will choose these in preference to foreign-made cars. Imports will be reduced and U. S. production—and employment—increased.

⁴This and the following examples abstract from certain effects that may follow the change in the exchange rates. For example, to the extent that the U. S.-produced tractor contains imported components or material, its dollar-price may be increased as the producer passes on its increased costs. Also, profit margins at various levels of distribution may be changed, or costs of production increased as volume rises. All these will influence the price outcome.

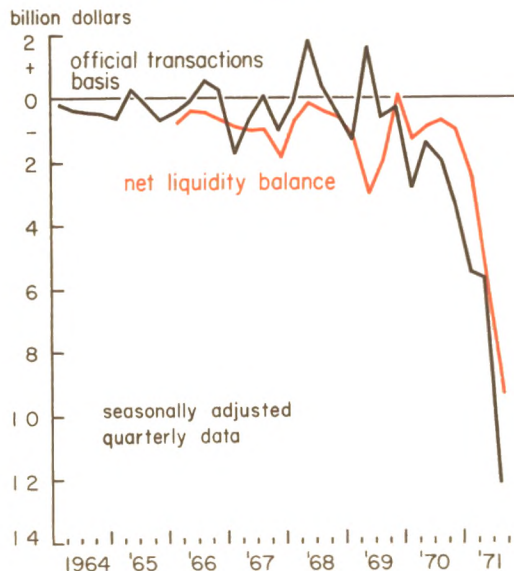
The combination of reduced imports and increased exports are expected to help improve the U. S. foreign trade balance. The improvement will be aided by the impact of foreign revaluation on the competitiveness of these countries in world markets. Not only will their sales in the United States be dampened and their purchases from the United States increased, but also the competitive price superiority of foreign business firms over U. S. producers in "third-country" markets will be reduced as a result of the appreciation of the value of their currencies relative to the value of other currencies.

But not all effects will be advantageous to U. S. residents—nor will only disadvantages accrue to residents of countries abroad. The realignment will mean higher prices on goods imported into the United States. Although finished imported goods represent a relatively small portion of total consumption

expenditures by U. S. residents, the effect of dollar devaluation will be felt by many who came to rely on cheap foreign-produced goods to provide greater variety—and larger amounts of buying power—to their budgets. Those traveling abroad will find that their dollars will buy less. Also, increases in prices of imported raw materials and components used in the production of U. S. goods may result in some price increases that will affect nearly everyone.

At the same time, consumers in the revaluing countries abroad will find their budgets "buying more." Imported goods—American-made goods—will cost less, and consumers will be able to substitute cheaper foreign goods for relatively more expensive domestically-produced goods. Other things equal, their standard of living will increase—while that of the Americans will be reduced somewhat. In this sense, the realignment of currencies will reward residents of revaluing countries for their past frugality, and for the productivity that enabled their economies to grow and gain competitively in world markets. At the same time, devaluation for most Americans will mean a collective payment on the bill for the Vietnam war, wage increases in excess of productivity gains—in short, for the things that over the past several years have contributed to inflationary pressures in this country and thus undermined the external value of the dollar, making the change in parity essential.

... and improve U. S. balance of payments



... and of other measures

In addition to realigning the exchange parities of currencies, or establishing new central values, representatives of the major countries and the officials of the International Monetary Fund, meeting in Washington, agreed to widen the "band" of permissible deviation from parity of the "fixed"

exchange rates. Under the old system, the exchange rate of the currency of any one country relative to the dollar was permitted to deviate by not more than one percentage point either below or above the officially declared par value, or a total "band" of 2 percent. As the limit was approached, the authorities were obliged to enter the market to support the fixed rate.

In the opinion of many observers, this relative rigidity of exchange rates was conducive to speculation in the foreign exchange markets under certain conditions, and was often too confining for national authorities in their pursuit of domestic policy objectives. Speculative activity—that is, transferring funds, say, from dollars to another currency in anticipation of a quick profit from changes in the par value—was made relatively "safe" under the 2 percent band. A speculator stood to lose, at a maximum, 2 percent on his speculative transfer if his expectations were not realized. On the other hand, speculators could gain several times that much if the currency in which funds were placed was revalued. The widening of the band of permissible fluctuation, from 2 percent to 4.5 percent (i.e., from 1 percent on each side of the par value to 2.25 percent), increases the extent of a possible loss and, thus, is expected to discourage disruptive speculation. Moreover, wider movement of the exchange rates will permit a better accommodation of the exchange rates to changing economic conditions in individual countries. It will make formal, relatively large changes in parities less likely, while at the same time, small and more frequent formal changes can be undertaken more readily. This, too, is expected to reduce speculation.

The wider band of fluctuation also should permit greater divergence in monetary conditions without giving rise to disruptive

short-term capital flows. For example, a higher level of interest rates, maintained by monetary authorities in an effort to restrain domestic economic activities, could be better sustained without attracting negating inflows of foreign capital. The reason: with a wider band for exchange rate movement, foreign investors stand to lose more through possible movements in exchange rates than they stand to gain on the interest rate differential in the different national markets.

Conclusion

Just as it is the function of a national monetary system to facilitate domestic commerce, so the primary function of the international monetary system is to facilitate exchange of goods, services, and productive capital across national boundaries among nations of differing internal monetary systems. Over time, monetary systems of individual countries evolved and changed in response to the changing nature of economic activity so as to continue to best perform their basic functions. The international monetary system, too, has been undergoing many changes. At times, however, the inertia arising from divergent national interests has meant that desirable changes have been slow in coming. Pressures accumulated and disruptions ensued. Over the past several years, the trading nations of the world have been confronted with such a situation. But they have risen to the challenge, and have embarked on a collective effort to resolve the accumulated problems. In the background of these negotiations were and are real economic issues: how to assure smooth flows of trade and capital, on which virtually all nations rely for their economic well-being within the framework of a noninflationary world that assures full employment and a rising standard of living to all. Negotiations

still continue and many issues remain to be resolved. Gold, its price in terms of various world currencies, has been one of the issues. But against the background of the real economic issues that have formed the framework of negotiations, the gold issue has been largely stripped of its mysticism. The question has not been: What price gold? The question has been: What will be the price of European cars, American steel, Canadian wheat, Japanese television sets, and Hong Kong textiles in world markets that will maximize production and employment, and economic well-being, for all?

Over the centuries, gold has performed a useful, indeed a vital, function in the evolution of both national and international monetary systems. But as the complexities of economic relationships increased, the practical usefulness of gold diminished. Many years ago, close links between gold and national monies became too confining to permit full realization of economic opportunities within individual economies. Acting individually, all nations have freed themselves from this confinement by cutting the link between gold and their domestic monetary systems, and by successfully substituting monetary management unencumbered by the vagaries of gold.

In the international monetary area, the demise of gold has been far slower in coming than it has in individual economies. While diminished in relative importance, gold continues as a significant portion of the international reserves of many countries.

For nations, just as for individuals, any-

thing widely acceptable as a medium of exchange, as a claim on real goods and services, is money. Gold continues as international money among official institutions because it has been accepted by a majority of nations as such. It is so accepted because governments that in the past, have used their nation's energies in securing their gold hoards have a vested interest in insuring that these hoards continue to command real resources. Because of this, gold will play a role in the international payments arrangements for many years, perhaps until nations, through mutual trust and international discipline, are prepared to accept "credit" money—and the advantages that such money offers—as readily and universally as individual citizens within individual nations have accepted it for many years. When that time comes, official gold hoards can be put to good uses.

That time may be far away—but certainly much closer than it appeared only a few years ago. The foundations for a more rational system have been laid by the acceptance in principle of the new international money—the Special Drawing Rights (SDRs). Building on these foundations progresses. Gold is no longer dug out of the earth so that it can be buried at heavily guarded underground vaults at another location as official reserves. The broad acceptance of the SDRs so far, and the continued ongoing search among nations to reconcile their differences for the common good, hold great promise for the future—and dull the glitter of gold.

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Business Conditions

*a review by the
Federal Reserve Bank of Chicago*



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